Limited-Dividend Approach to Housing

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Community Development Corporations and the Limited-Dividend Approach to Housing

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PREFACE

This three-part monograph is designed to provide community groups (and their advisors) with an effective review of the issues and strategies for one kind of housing development -- namely, a limited-dividend (for-profit) enterprise. The specific cases used for illustration depend upon support under the Section 236 program of the Federal Housing Administration. However, the same issues and strategies are, for the most part, apparent in other kinds of housing development under a limited-dividend approach with other mortgage mechanisms.

An earlier CCED monograph (James L. Morey and Melvin Epstein, Housing Development: A Tool for Community Economic Development in Low-Income Areas, CCED, 1971) serves as an introduction to housing development by community groups, especially using the limited-dividend approach. That monograph considered a specific case of financing housing rehabilitation by a community group. The present monograph focusses on new housing development, but it assumes a basic familiarity with the material introduced in the earlier publication. All of the case material on the financing and other problems presented in this publication comes from actual projects completed or now underway in the housing development programs of community-based organizations with which the authors have worked. However, to protect the confidentiality of the negotiations, the actual names and places have not been used.

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Section I

Limited-Dividend Sponsorship: The Limitations and the Dividends

Housing for low- and moderate-income families is a compelling objective for community development corporations. Improved housing conditions may be a pre-condition or serve as a focus for further economic activity in the community, such as new commercial or industrial development. The process of providing housing may, in addition, offer job opportunities for local residents in the construction industry, in real estate management, or in other housing-associated businesses. Finally, housing development can generate income for the CDC which can be applied toward realizing other community goals.

If housing is to be a primary objective, what are the mechanisms by which this objective can be accomplished to the maximum benefit of the community? In particular, what are the advantages and disadvantages of nonprofit versus limited-dividend sponsorship of housing by a CDC? [1]

FINANCING PROGRAMS

For purposes of this discussion, it will be assumed that housing will be developed under Section 236 of the National Housing Act. [2] S. 236 is a rental assistance program for low-and moderate-income families, reducing rents through interest rate subsidies. An effective percent interest rate for a 40-year mortgage term is provided under this program. I will further restrict the discussion to the nonprofit (NP) and limited-dividend (LD) forms of sponsorship under the S. 236

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1. The term "sponsor" is the term employed by HUD/FHA to describe the developer and/or owner of a nonprofit or limited-dividend project.

2. Alternative housing assistance programs that may better suit a particular community's needs are: S. 235 home ownership, leased public housing, turnkey public housing, S. 312 rehabilitation loans, rent supplements with market rate financing, etc. It should also be noted that S. 236 subsidies may often be available in conjunction with state or local housing financing programs.

program.[3] Tables I.1 and I.2 present development and operating budgets for a typical 200-unit housing project, comparing these alternative forms of sponsorship. The reader should be familiar with the schedules before proceeding.

Nonprofit (NP) rather than limited-dividend (LD) would at first appear to be the proper form of sponsorship for a CDC to assume in developing housing. "Nonprofit" describes the motivation of most community-based sponsors and suggests that the project costs and monthly rents will be held to a minimum. Also, with NP sponsorship, financing is provided for 100 percent of the project costs, thus eliminating the need for equity investment. In fact, when the first nonpublic housing programs for lower-income families were introduced in the early 60s, emphasis was given to the nonprofit form of sponsorship.[4] The prevailing wisdom at the time was that limited-dividend sponsors would not be attracted to such programs.[5] The actual experience has been that LD sponsors have predominated in low- and moderate-income housing. Let us examine the financial differences between these alternative forms of sponsorship in greater detail.

The essential differences between NP and LD sponsorship as shown in Tables I.1 and I.2 can be outlined as follows:

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3. A third alternative, cooperative sponsorship, is assumed to be similar to the nonprofit form for the purposes of this paper. However, there are significant differences in ultimate ownership and tax benefits.

4. The 1961 amendments to the National Housing Act established the S. 221(d)3 Below-Market Interest Rate (BMIR) program for low- and moderate-income housing. The S. 221(d)3 BMIR program provided a 3 percent interest rate, 40-year loan. Previously, this BMIR loan form had been introduced for elderly and college housing.

5. The S. 221(d)3 program originally allowed for nonprofit, cooperative, and limited-dividend sponsorship, but the sponsor had to be a corporate entity. It was not until a partnership form of ownership was allowed that the limited-dividend approach was activated.

Table I. 1 - Comparison of Nonprofit and Limited-Dividend Development Statements for 200 Garden-Type Units Financed Under FHA S. 236.

Development	Nonprofit		Limited-Dividend	
Construction costs		$3,000,000		$3,000,000
Professional fees		345,000		195,000
General overhead	$ 60,000		$ 60,000	
Builder's profit	150,000		000	
Architect's fees	120,000		120,000	
Bond premium	15,000		15,000	
Carrying and financing		470,500		364,500
Interest	$140,500		$129,600	
Taxes	15,000		15,000	
Insurance	10,000		10,000	
FHA fees	52,200		48,200	
Financing	80,300		74,100	
AMPO	80,300		000	
FNMA fee	60,200		55,600	
Title expense	12,000		12,000	
Legal expense	20,000		20,000	
Builder's and Sponsor's Profit and Risk Allowance		000		355,900
Total development cost		$3,815,500		$3,915,400
Land acquisition		200,000		200,000
Total replacement cost		$4,015,500		$4,115,400
Mortgage amount		- 4,015,500		- 3,703,900
Equity requirement		$ 000		$ 411,500

Table I. 2 - Comparison of Nonprofit and Limited-Dividend Operating Statements for 200 Garden-Type Units Financed Under FHA S. 236.

Operating	Nonprofit		Limited-Dividend	
Average monthly rent		$144.25		$148.15
Gross annual income		$346,270		$355,520
Vacancy		- 17,310		- 17,780
Gross effective income		$328,960		$337,740
Annual expenses		150,000		150,000
Management	$16,500		$16,500	
Operating	80,000		80,000	
Maintenance	38,500		38,500	
Reserves	15,000		15,000	
Real estate taxes		- 49,340		- 50,660
Net income		$129,620		$137,080
Debt service	$121,830		$112,390	
Cash flow	000		24,690	
Reserve fund	7,790		000	

1. The average monthly rent for the LD project is approximately $4 per month greater than for the NP project. This is due primarily to the increased net income requirements for the LD project, given a greater replacement cost and a slightly higher net earnings or capitalization rate based on that replacement cost.[6] The rental increase is caused secondarily by increased management fees, real estate taxes, and vacancy allowances which are calculated based on rents. In other words, for each $1 increase in rents, these fees, taxes, and vacancy allowances are also increased as a percentage of that increase.

2. Given the same construction costs, the LD project's replacement cost is greater than that of the NP project. This is because the LD project is allowed a Builder's and Sponsor's Profit and Risk Allowance (BSPRA), calculated as 10 percent of all development costs, exclusive of land acquisition; the NP project budget includes only a 5 percent builder's profit calculated on construction costs. However, as a partial offset to the BSPRA, the LD project has reduced carrying and financing charges, since many of these charges are calculated on the mortgage amount which is less for the LD project. Also, the NP project provides a 2 percent working capital allowance (AMPO) within the mortgage structure; this allowance is not included in the mortgage for the LD project, but must be provided for separately as will be explained below.

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6. "Net income" is defined as the annual amount required for debt service (interest and principal), cash flow, and any other residual payments (reserves). "Net earnings" or "capitalization" rate refers to the percentage relationship between the project's replacement cost and the annual net income requirements. In other words, this percentage is used to calculate the amount of money that must be generated each year to support the original cost of producing the housing. Under S. 236, the debt service payments for a 1 percent, 40-year loan are 3.034 percent of the mortgage annually (i. e., 3.034 percent is the annual constant rate necessary to pay 1 percent interest on the balance of the mortgage and to repay the principal amount of the loan in 40 years). For a NP project, 94 percent of net income is applied to debt service and 6 percent to a general reserve; therefore, the net earnings or capitalization rate is 3.228 percent (3.034% divided by 94%). For a LD project, 90 percent of the replacement cost (the mortgage) must earn at the debt service rate and 10 percent of the replacement cost (the equity) earns at 6 percent, the maximum cash return on equity allowed; hence, the net earnings or capitalization rate is 3.331 percent [(3.034% x 90%) + (6.0% x 10%)].

3. The mortgage amount for the LD project is less than the mortgage for the NP project, even though the replacement cost for the LD project is greater than that for the NP project. The reason that the mortgage amount is less is because under LD financing the mortgage represents only 90 percent of costs, while under NP financing the mortgage is for 100 percent of costs. [7] The difference between the replacement cost and the mortgage amount is the equity required. For the LD project 10 percent of the replacement cost represents equity which the sponsor must provide; there is no equity requirement for the NP project. In addition, the LD project has a working capital requirement equal to 2 percent of the mortgage; this requirement is not covered by the mortgage. [8] As stated previously, this working capital requirement is included in the mortgage for the NP project under AMPO.

To summarize the above analysis, it can be stated that the difference in average monthly rents between the NP and LD sponsored projects is relatively minor (approximately $4 per month greater under LD). Given the same construction costs, the replacement cost for the LD project is somewhat greater than for the NP project, owing to the net effect of various fees and expenses included in the replacement cost formulas. The most significant difference between the two forms of sponsorship is the equity and working capital requirements: for the NP project,

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7. It should also be noted that the S. 236 subsidy amount calculated as a percentage of the mortgage. Given an FHA market interest rate of 7 percent for a 40-year term (plus a 1/2 percent mortgage insurance premium), the subsidy rate is equal to 4. 9192 percent. Applying this rate, we find that the annual subsidy for the NP project is $197, 520 and for the LD project, $182, 190. Hence, since the LD mortgage is less than the NP mortgage, less subsidy is required to support the 200 units of housing. Conversely stated, with LD sponsorship, more units of housing can be provided than with NP sponsorship, given the same subsidy amount. The subsidy amount is paid by HUD periodically to the lender.

8. The working capital requirement is short-term, usually covering the period from initial close to final close or until the project is fully completed, occupied, and operating properly. This requirement can often be satisfied by a letter of credit or other device

these requirements are covered totally by the mortgage loan; for the LD project, an equity requirement equal to 10 percent of the replacement cost and a working capital requirement equal to 2 percent of the mortgage is not covered by the mortgage loan and must be provided by the sponsor from other financial resources. In the example given, the equity plus working capital requirements amount to $485,600.

These requirements might seem prohibitive to many potential CDC or other community-based LD sponsors. However, the analysis has not yet taken into account the Builder's and Sponsor's Profit and Risk Allowance (BSPRA). To the extent that the BSPRA does not have to be paid out as a fee to a builder or others, this allowance can be used to offset equity or working capital requirements.[9] In other words, the sponsor's share of this allowance can be applied against the cash requirements. If the BSPRA had been called the Builder's Profit and the Sponsor's Risk Allowance, this point would be more obvious. The effect of applying the BSPRA in this manner is to make the LD net cash requirement less than the total equity required as can be seen in Table I. 3. Thus, after taking account of BSPRA, the net cash requirements are reduced to $279,700. Even with these reductions in the cash equity, the net requirements still appear to be prohibitive for the CDC sponsor under LD. However, the missing factor in the LD development formula will more than make up the difference. This factor is the tax incentives available to LD sponsors.

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rather than cash, but the more conservative assumption is applied in this analysis.

9. The builder is often able to earn a satisfactory fee directly out of the construction contracts instead of charging an extra fee over and above the contract price. This possibility is dependent on the size of the job and tye type of subcontract trades the builder is equipped to handle directly. However, in this analysis the more conservative assumption is applied, and a builder's fee equal to 5 percent of construction costs is used. (For an alternative treatment of the builder's fee, see Section II; in that section the builder's fee is paid out of syndication proceeds, but the net effect is the same.)

Table I. 3 - Calculation of Net Cash Requirement for an LD Project

Total replacement cost		$4, 115, 400
Mortgage (90% of replacement)		-3, 703, 900
		411, 500
Working capital (2% of mortgage)		+ 74, 100
Total equity required		485, 600
BSPRA	355, 900	
Builder's profit	-150, 000	
Sponsor's risk allowance	205, 900	- 205, 900
Net cash requirement		279, 700

(All figures in this calculation come from Table I. 1)

DIVIDENDS OF LIMITED-DIVIDEND

Under current federal (and state) tax regulations, substantial tax advantages are granted to profit-motivated developers or owners of real estate. These tax advantages or tax incentives provide for profits independent of development and operating costs borne by the tenants. In effect, by forgoing taxes which it would otherwise collect, the government pays these profits. The tax treatment of a project constitutes an important indirect subsidy to housing.

These incentives take the form of tax deductions created by construction expenses and depreciation allowances.[10] Such deductions result in losses for tax purposes during the early years of a project's operation, and these losses in turn result in tax savings when applied against taxable income from other sources. For example, if a project generates a \$40,000 loss in a given year and this loss is applied against income of \$100,000, taxable income is reduced to \$60,000; assuming a 50 percent tax bracket, a tax savings of \$20,000 results. (50% x \$100,000 less 50% x \$60,000.) Since, in effect, the tax losses protect income from taxation, these incentives are also referred to as tax shelters.

It should be noted that although losses are reported for tax purposes, the project should actually be realizing a positive cash flow; that is, after all expenses and mortgage payments are accounted for, there is

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10. Certain of the costs of construction can be expensed immediately in the year that they occur. These costs include such items as construction interest, financing fees, government fees, real estate taxes, etc. The balance of the project costs are capitalized and depreciated over the useful life of these costs, except for certain nondepreciable costs such as land. For a project of this type, the average useful life is 30 to 40 years. The simplest approach to depreciation is the "straight line" method; for each year of the depreciable life of a cost component, an equal amount of that cost is deducted. However, residential real estate is eligible for "accelerated" methods of depreciation; using these methods a greater amount of the cost is deducted in the early years and a decreasing amount over the remainder of the useful life. The most common accelerated methods are 200 percent declining balance and sum-of-the-years-digits.

a surplus remaining from rents collected. Again, the reason for this difference between the tax and cash accounting is that depreciation allowances create a loss without representing a real expense to the project. In the case of an LD project, the distributable cash flow is limited to 6 percent of the original equity required. This cash distribution can be taken out tax free until the tax losses for the project run out (normally 15-20 years).

These tax incentives are often of such a magnitude that the sponsor cannot use all the benefit directly. Furthermore, there is a need to raise capital for equity requirements. This would be expecially true for a CDC sponsor. Therefore, the tax losses are usually sold to investors in high tax brackets. These losses can then be used to offset the personal income of the investors, resulting in tax savings as described. Investors also receive a share of the cash flow generated by the project. The usual vehicle for investment in a project of this type is a limited partnership, with the sponsor retaining an interest as general partner and selling the remaining interests to limited partners. The organization of such a limited partnership and the sale of such tax and cash benefits to investors is referred to as syndication. Recent changes in the tax laws have enhanced the incentives for investment of this type in housing, especially housing that is government assisted, by reducing incentives for other real estate and other tax subsidized industries.

A summary projection of tax losses and tax savings as well as cash flow distributions for the LD project previously described is presented in Table I. 4. The value of these benefits has been determined to be \$600, 000. [11] These proceeds from syndication, after making allowances

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11. The syndication analysis assumes 95 percent of the tax benefits and 95 percent of the cash flow is allocated to investors in the 50 percent tax bracket. These investors contribute capital in three equal installments at initial close, final close, and one year after final close. The project is sold 20 years after final close for \$1 over the mortgage balance, with the capital gains tax on sale being calculated at a 35 percent rate on the adjusted basis. Standard accounting assumptions are applied as regards construction expenses and depreciation deductions. The value of the syndication, based on a 15 percent discounted rate of return to the investors, is \$600, 000.

Table I. 4 - Projection of Tax and Cash Benefits

	Year	Income (Loss)	Tax Savings (or Cost) @50%	Cash Distribution	Total Benefits	Cumulative Benefits
1	1972	$(312,900)[a]	$156,450	$ 0	$156,450	$156,450
2	1973	(192,061)	96,031	24,690	120,721	277,171
3	1974	(179,651)	89,826	24,690	114,516	391,686
4	1975	(167,102)	83,551	24,690	108,241	499,927
5	1976	(154,413)	77,207	24,690	101,897	601,824
6	1977	(141,579)	70,790	24,690	95,480	697,303
7	1978	(128,585)	64,293	24,690	88,983	786,286
8	1979	(115,416)	57,708	24,690	82,398	868,684
9	1980	(102,069)	51,035	24,690	75,725	944,408
10	1981	(88,534)	44,267	24,690	68,957	1,013,370
11	1982	(99,214)	49,607	24,690	74,297	1,087,660
12	1983	(86,261)	43,131	24,690	67,821	1,155,480
13	1984	(75,923)	37,962	24,690	62,652	1,218,130
14	1985	(65,350)	32,675	24,690	57,365	1,275,500
15	1986	(54,538)	27,269	24,690	51,959	1,327,460
16	1987	(43,462)	21,731	24,690	46,421	1,373,880
17	1988	(32,108)	16,054	24,690	40,744	1,414,620
18	1989	(20,456)	10,228	24,690	34,918	1,449,540
19	1990	(8,482)	4,241	24,690	28,931	1,478,470
20	1991	3,825	(1,913)	24,690	22,778	1,501,250
21	1992	33,906	(16,953)	24,690	7,737	1,508,990
Tax on sale						(673,461)
Net benefits						835,526

Note: The projection is based on the 200-unit LD project outlined in Table I. 1. See also footnotes 10 and 11 for further details and assumptions.

[a] Parentheses indicate losses or costs.

for the cost of syndication and other requirements, are more than sufficient to cover the cash requirements for developing the project and to realize a profit for the CDC. In summary:

Gross syndication proceeds	$600,000
Syndication cost (15% of gross)	90,000
Net syndication proceeds	510,000
Net cash requirements	279,700
Net profit	230,300

Thus, after providing for all cash requirements (which have been conservatively estimated) there is a net profit available to the sponsor of $230,300. This profit, however, assumes that no extraordinary development, operating, or syndication costs occur. It should also be noted that 15 percent of the gross syndication must be escrowed as net worth requirements under tax regulations if the general partner is a corporation (which is likely in the case of a CDC). Thus, the CDC in the case illustrated would end up with $140,300 as a cash profit from the project; an additional $90,000 would be maintained in an escrow account until the limited partnership is dissolved.

The available profit or surplus can then be used to accomplish various objectives of the CDC. For example, additional amenities could be incorporated in the project design, such as recreational or community facilities, more landscaping, better finish materials or appliances, and so forth. The profit could also be applied to special management services for the tenants, creating an emergency rental assistance loan fund, staffing a day care center, or providing other operating services. The proceeds could also be used to effect rent reductions -- the interest alone on this profit would be more than sufficient to offset the $4 per month increased rental under LD vs. NP sponsorship. Alternatively, these funds would be used to capitalize the development of additional housing or other financial ventures by the CDC. The tax incentives are therefore important indirect subsidies which the CDC sponsor can apply to satisfy the LD equity requirements and still realize a profit which can be used to provide additional amenities for a given project or to initiate other projects. These benefits accrue to the LD sponsor for no

additional development effort, except for the syndication process, the cost of which has been allowed for in the analysis. Neither is there any adverse effect on construction costs or rents except for the $4 per month differential in rent previously noted. The tax benefits function largely independently of rents or of the actual development and operations of the project, representing "paper losses" and in no way reflecting real deficiencies in the project. Of course, there are risks and responsibilities of LD sponsorship, not the least of which are development cost overruns or operating expense deficiencies. However, NP sponsors must also face these liabilities but without the margin or cushion provided by the tax incentives and their inherent syndication value.

LIMITATIONS OF LIMITED-DIVIDEND

The potential profits represented by the indirect subsidy of the tax incentives, however, are by no means automatic profits. The CDC should carefully evaluate the limitations of LD sponsorship before committing itself to this course of action. The limitations are basically of two types: organizational restrictions and syndication constraints.

A CDC or other community housing sponsor is normally organized as a nonprofit entity, often tax exempt. In order to participate as the general partner of a LD syndication, it is generally assumed that a taxable entity is required, necessitating a change in the status of the parent organization or the creation of a qualified subsidiary. Perhaps more important than the legal technicalities is the subjective effect of this change. The CDC must be prepared to satisfy its constituents that the "profits" realized are not at the expense of the community. Undoubtedly, this change in status from nonprofit to profit will cause some consternation unless the sources and applications of the proceeds are clearly defined.

It should also be noted that there are real cash obligations under LD sponsorship in comparison to NP sponsorship where 100 percent financing is available. In particular, the LD sponsor must be prepared

to evidence a capitalization equal to or in excess of the direct equity requirements and working capital before construction starts. As has been shown, a tax syndication should be more than sufficient to raise the necessary capital. However, under normal circumstances, syndication does not take place until construction starts, and syndication proceeds are often restricted until construction is completed. Therefore, acting as an LD sponsor may tie up considerable resources to satisfy the capitalization requirements in the interim.

A CDC should also consider the implications of involving community-oriented housing in an LD syndication. The investors are likely to be wealthy individuals whose concerns may be far removed from the community's interests. (This is assuming that the investor is not investing partly out of a "social consciousness"; such socially motivated investors are not highly visible, however, and CDCs should not predicate a syndication on this assumption.) This difference in purpose may cause compromises in the original housing goals in order to accommodate the investor, or other conflicts may result from developing and operating housing in a way which will support returns to such investors. For example, a part of the investment benefit consists of cash flow generated by tenant rents. In order to maintain this cash flow in the future, rent increases may be required. Alternatively, the CDC's own profits from syndication could be used to offset rent increases, but this curtails the use of such profits for other community purposes. This is an obvious conflict of interest for the CDC LD sponsor that finds itself between the investor group and the community/tenant constituents.

In return, the investment market perceives these complications in the development and operation of a community sponsored LD project. In addition, the market questions the technical experience and financial stability of a community sponsor. These perceived risks may cause investors to demand a premium return on their investment, if they are willing to invest at all. Naturally, a higher return means reduced profits to the community organization. Investors may also exact guarantees, escrows, or other restrictions on the use of syndication proceeds which may further reduce the margins available. Basically, investors would

prefer dealing with "professional" developers, and as long as such competing investment opportunities exist, a community based LD sponsor will probably receive less profit on its tax shelter syndications. To put it more crassly, the investor market is uneasy enough about investing in housing for poor people, but when the poor people are also in charge of development and management ....

JOINT VENTURE: A PRACTICAL COMPROMISE

It is therefore apparent that very real limitations do exist for a CDC LD sponsor, limitations that may well cancel out the potential benefits that can be derived from this form of sponsorship. Before abandoning the concept, however, consider the possibility of joint-venturing an LD project with a professional developer. This approach represents a compromise insofar as some development control is relinquished by the community. However, in return the community gains the technical and financial resources and the experience of the outside developer. In addition, the marketability of the tax shelter syndication is improved. This makes the joint venture a practical compromise.

Clearly, there are advantages for the community in this compromise, but why would a developer be interested in such a joint venture? Indeed, the line of least resistance for an outside developer is to avoid the complications of aligning himself with a community organization. The CDC, therefore, has to exercise its natural prerogatives carefully in order to precipitate such a joint venture. The CDC has two kinds of leverage: political influence and independent funding.

Political influence or "turf power" is in effect a veto power over housing or other development which is not responsive to the community needs. This veto is exercised through public hearings on urban renewal, zoning approvals, building permits, or through other procedures which are subject to political influence; there are, of course, extralegal activities that can be used to exert pressure on a particular issue. In short, an organized community can block developments which are deemed adverse in their impact and assist developments which are in the community's interests.

Independent funding exists if the CDC has received private or public funding for its activities in the community. For example, OEO Special Impact funds provide for economic and physical planning and even land acquisition. In addition, the CDC may have special access to land writedown funds, subsidy reservations, or other discretionary public monies on the federal, state, or local level. Using these resources, the CDC can create a plan for its community, initiate and expedite projects, and otherwise create a development package beyond the scope of an individual developer's capacity.

To demonstrate these community advantages, let us look at two possible scenarios for a joint venture. Scenario A represents a situation in which the CDC exercises its "turf power" to influence the development of a project within the community; Scenario B involves a project initiated by the CDC which then takes on a developer as a joint venture partner. Both scenarios are derived from actual experiences of the author. Included as Appendixes 1 and 2 are outline agreements which are based on these scenarios and which may be useful references. In particular, these agreements begin to detail the many issues of control, responsibility, risk, and profit which are the ingredients of any housing development of this type. These are by no means exclusive forms of agreement for the alternative approaches, and each circumstance must be resolved on its own merits.

Scenario A portrays a situation in which a developer has independently acquired a property in the community. A zoning approval is required to proceed with the development, and the community agrees to support the request for a variance if certain conditions are met. These conditions include certain design changes, assurances that a number of the units will be for large, low-income families, a specified management and lease policy, plus participation in the tax syndication proceeds. The developer must then weigh his chances for success without community support, or his options for other projects in a less demanding community, against the concessions

required for this project. The CDC in turn will have to negotiate each circumstance on its merits; such negotiations require a flexible and realistic attitude on the part of the community as well as the developer.

Scenario B involves a situation in which the CDC has secured options on a number of properties in the community and has prepared preliminary architectural plans for rehabilitation of the housing, utilizing its OEO funding. A reservation of funds under leased public housing has also been obtained. The CDC then invites "bids" from developers to joint-venture the housing. The bids are evaluated based on the developer's conformance with the criteria established for project development and management, plus, again, willingness to share the tax syndication proceeds with the community.

In the end, the most favorable relationship negotiated is the one in which the developer acts as a consultant for a fixed fee based on syndication. The developer lends experience and credibility to the enterprise without assuming real risks, and the CDC maintains control. However, under other circumstances, control and risk could be shared along with profits.

Inevitably, there will be conflicts of control and participation under either joint venture scenario. However, the CDC has placed itself in the position of influencing project development and operations as well as receiving "a piece of the action." There is no set formula for a fair disposition of profits, this being largely a function of the negotiating power and ingenuity of the community. Clearly, however, the CDC can expect less control and participation in Scenario A where the community simply supports the project than in Scenario B where the project was initiated by the community. The joint venture approach, especially for the first development projects undertaken by a CDC, may not only increase the chances for success, but may actually increase the profits realized by the community as well. In other words, 50 percent of a big pie may be better than 100 percent of a smaller pie and certainly better than 100 percent of no pie at all.

SUMMARY

Evaluating the alternative forms of sponsorship (nonprofit versus limited-dividend) demonstrates that there is no substantial financial advantage in development or operating costs when the nonprofit approach is used. The distinct disadvantage with nonprofit sponsorship is the loss of tax incentives available to limited-dividend sponsors. These tax benefits, the value of which is realized by the CDC through a limited-partnership syndication, are sufficient to cover all equity requirements and still realize a substantial profit. These dividends, therefore, represent a potentially large subsidy which can be applied toward improving the housing developed or toward achieving other community purposes.

However, there are problems that result from the CDC modifying its "not for profit" status in order to participate in the syndication process. Moreover, a CDC limited-dividend sponsor may have difficulty syndicating its projects, since the investment market tends to discriminate in favor of the professional developer. Given these limitations, the CDC might be well advised to joint-venture a project with an established developer. The joint-venture approaches outlined above suggest ways in which a CDC might use its influence and resources to review or initiate projects in its community, exercise control over the development and management of the project, and participate in the tax syndication proceeds. These strategies utilize the inherent leverage of the CDC to best advantage while reducing the impact of its limitations. The CDC thus puts together a viable mechanism for providing more and better housing for the community.

APPENDIX 1. SCENARIO A -- JOINT VENTURE AGREEMENT

The Community Development Corporation ("CDC") agrees to withdraw its challenge to the variance granted for the property known as Garden Towers and agrees to support the proposed development of the site, provided that Professional Development Corporation ("PDC") or its assigns, acting on behalf of the property owners, agree to the following conditions:

1. At least 25 percent of the housing units built on the site shall be available at rents for low- and moderate-income families as defined by the exception income limits of S. 236 of the National Housing Act. Furthermore, at least 80 percent of the gross square footage of the development (exclusive of parking garages and public spaces) shall be devoted to residential uses.

2. The CDC shall be granted an equity participation in the project equal to 15 percent of gross syndication proceeds. Gross syndication proceeds are defined as the dollar value of the tax benefits and cash flow accruing to the project owners, assuming 95 percent of such tax benefits and cash flow are sold to limited partners. As defined, the equity participation is calculated before consideration of syndication costs, cash equity requirements, cost overruns, administrative salaries, or any other obligations, and is calculated irrespective of the actual percentage of tax benefits and cash flow that is syndicated. The 15 percent participation will be paid to the CDC proportional to investor contributions commencing with the initial closing of the project, provided that all such payments are made within a three year period from the initial closing. Furthermore, the CDC shall be assigned a general partner status equal to 25 percent of the total general partnership, representing its share of ownership control and residual position.

3. If at least 25 percent of the housing provided is not at low- and moderate-income rents, or if the CDC should provide capital or other resources to the project, the proposed equity participation shall be renegotiated to the mutual satisfaction of all parties.

4. The CDC shall appoint a five-member committee ("The Committee") empowered to represent the CDC in all decisions regarding project development. The actions of the committee shall be binding on the parent body until the committee is dissolved or reconstituted. The committee shall be the sole representatives of the CDC (apart from consultants) authorized to speak for the community's interests, attend meetings related to project development, and otherwise exercise the conditions of this agreement. The committee shall in turn report all actions and review all decisions with the CDC at large. PDC shall supply the committee with all pertinent information and inform the committee about all critical events required for the committee to perform its duties.

5. The CDC, through its special committee, shall have the power to nominate and/or veto the following principals in the development process: (a) consultants, (b) contractor, (c) architect, (d) management. Each of these parties shall in turn agree in writing to the terms of this agreement as a condition to selection.

6. The CDC through its special committee shall review and approve the following documents before these documents shall take force: (a) mortgage application (feasibility and final submission), (b) architectural plans and outline specifications, (c) management plans and agreements (including lease); (d) limited partnership agreement.

7. PDC shall provide an escrow account of $10,000 which the CDC or its special committee can draw on for hiring legal, engineering, or other technical counsel for matters related to the project. All monies expended from the escrow account shall be deducted from the first payment due the CDC as its equity participation.

8. The project shall not abridge the intent of the proposed zoning revisions now under consideration by the planning board, especially as regards height, aspect, density, and bonus provisions.

If the conditions of this agreement are not met by either party, the variance granted for development of the project shall be considered null and void.

APPENDIX 2. SCENARIO B -- JOINT VENTURE AGREEMENT

This agreement is intended to outline a proposal for the development of low-income, limited-dividend, rehabilitation housing to be undertaken by your organization, Community Development Corporation (hereinafter referred to as "CDC"), and with the assistance of Professional Development Corporation (hereinafter referred to as "PDC").

1. CDC will be the developer of record and will control the mortgagor entity of the projects contemplated. At this point, it is our understanding that the initial development will be approximately 100 units, although this in no way categorically delimits our relationship.

2. PDC will assist in any and all matters related to the acquisition, financing, development, construction, syndication, and property management of the developments. PDC will use its staff and best efforts to expedite any and all of these matters. PDC will also supervise, when requested, the progress of same.

3. Furthermore, PDC, through its wholly-owned construction subsidiary, will, if requested by CDC, enter into a cost plus construction contract with the mortgagor. PDC will waive the builder's profit and will build for the amount allotted for the contractor, after having waived the builder's profit. PDC will look to general overhead and, in the case of the contractor doing his own subcontracting, any mark-up that may be allowed the contractor under said circumstances.

4. PDC will use all of its management staff and general expertise to help the mortgagor establish management operations. It is our intent that CDC foster indigenous management operations. However, PDC will take on the management contract at the allowed fee, if requested by CDC.

5. PDC will use its best efforts to syndicate the equitable interests arising from the proposed developments. PDC will require an overhead fee allowance for syndication in the amount of 10 percent of the gross sales price -- to be paid by CDC as the money flows (i. e., in accordance with the scheduling of investor payments to CDC).

6. PDC jointly with CDC will establish, on a 60 - 40 basis (60 - PDC; 40 - CDC), an overhead pool for the express purpose of retaining

a housing consultant. CDC will advance the full amount for the above consulting fees -- to be reimbursed by PDC in the amount of its pro rata share upon initial endorsement of the first development. The services of the consultant will be for the mutual benefit of both parties as it specifically relates to the development of said rehabilitation housing. Both parties will agree upon the specifics of this consulting agreement and will jointly contract with said consultant.

7. In return for the above enumerated services, PDC will be paid by CDC the amount of 25 percent of the gross syndication proceeds, on the basis of the maximum permissible percentage of ownership being sold, subject to IRS net worth and safe haven requirements and other tax implications. This will be paid as the money flows. If PDC is, in fact, the builder, it will accept any and all contingencies that accompany the receivables running in favor of CDC as payment by the investors. In short, if CDC's payment is contingent, the same will hold for PDC's payment. If, however, PDC is not the builder, it will request a separate guarantee from CDC as to the payment of its fee, again in accordance with the schedule of investor payments.

8. If PDC is not builder, by choice of either CDC or PDC, its payment will be 25 percent of the adjusted gross proceeds -- adjusted by the amount that CDC decides to pay the contractors on an arm's length basis. In either case, PDC will work with local contractors so that indigenous labor and/or firms may be involved to the greatest extent possible in the production of this housing.

9. In order to help CDC meet its "matching funds" requirement, PDC will itemize and attribute all of its overhead related to this relationship.

Section II

Considerations in Packaging a Product

INTRODUCTION

When community groups act as developers of a specific type of housing -- namely, a limited-dividend (for-profit) enterprise under the FHA Section 236 program — not only the mortgage support of FHA but also a variety of potential arrangements in the community's relationship with a builder and with investors are involved.[1] A step by step analysis of the packaging procedure should be useful.

This section begins by describing FHA mortgage processing, then explores the different types of financial relationships that the community group might choose. Examining a real case still in the process of being packaged, the section presents specific financial figures to illustrate how the pieces have to fit together. (The author is serving as a consultant to the community group concerned.) This community group is the sole developer and contracts with a builder, but other kinds of relationships with a builder can also be chosen that would change the finance and development problems to be faced. These other choices are presented so that a community group can see what considerations are involved with regard to profitability, control, and attractiveness to investors.

Finally, the section presents a number of considerations that a group must look at when making a deal with outside investors. All of these will also affect the profitability and degree of control held by the community group.

FHA/HUD PROCESSING PROCEDURES

The developer hopes to develop a multiple unit project under Section 236 of the Federal Housing Law. He must locate a specific piece of land which is suitable for the kind of development he would

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1. This paper assumes an understanding of the basic elements of the limited-dividend form of sponsorship described in <u>Housing Development: A Tool for Community Economic Development in Low-Income Areas</u>, by James Morey and Melvin Epstein (Cambridge, Mass., Center for Community Economic Development, 1971).

like to see in the community and proceed to hire an architect and builder to determine in a preliminary way whether a project on that site is feasible. The aim of this initial effort is to collect enough basic information to have a prefeasibility conference with the local FHA office. Architectural drawings are not necessary at this time.

At the prefeasibility conference the potential developer describes the general nature of the proposed project. HUD expects the developer to demonstrate the need for the proposed housing. This is done by comparing the rough estimate of rent levels and operating costs in the proposed project to current rent levels and vacancy rates in the area. The developer presents his view of the project's rentability and the attitude of the community toward such a project. He will probably be called upon to indicate the proposed number of units with estimates of construction costs, taxes and operating expenses, and total replacement cost. The function of this conference is to let the HUD office know of his plans so that HUD has the opportunity to offer its view of the project's feasibility at an early stage. This conference assumes that the developer has control of a site, either through option or ownership.

Assuming that HUD gives a favorable judgment on the potential of such a project, the developer then begins work on the next stages, which include a management plan for the project and an application for a letter of feasibility. HUD has put increased emphasis on the management of low-income housing, since this has proved to be a serious problem in many inner-city areas. A good management plan is a crucial element for obtaining FHA approval; however, I will not go into the details of a management plan in this section. [2]

The key part of the application for a letter of feasibility is submitting an FHA 2013 Form, Application for Project Mortgage Insurance, which is included in this section. The FHA 2013 Form con-

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2. HUD has developed a management guide book which should be referred to. For details on a management plan, see Management of HUD Insured Multi-Family Projects under Section 221(d)(3) and Section 236, a HUD guide, HM G4351, July 1971.

tains the basic financial elements that must be considered in planning a project. The information supplied on the 2013 Form will determine whether the proposed rent levels can support the mortgage payments, the operating expenses, and the 6 percent cash distribution on the "implied equity."[3] The size of the mortgage is limited by the rents that can be charged.[4] The amount of rent that can be charged is restricted by FHA tenant income limits, which are 135 percent of the income limits established for public housing.[5] For instance, in Boston, Massachusetts, the 236 income limit for a family of four is $7,695 as of February 1970. The maximum basic rent for initial occupancy is 25 percent of the income limit or $160 per month in Boston for a family of four. Families whose income is lower than the income limit can be admitted but they will be paying more than 25 percent of their income for rent.

From one to six months after submittal of the 2013 Form and related documents such as Evidence of Site Control, Location Map, Personal Financial and Credit Statement of Sponsor, and Equal Employment Opportunity Certification, the HUD Area Office will call the proposed sponsor in for a feasibility conference. No architectural drawings are required at this point nor are there any HUD fees. At this conference, there is a more detailed discussion of market and economic feasibility, project location, site layout and design, and management plan. If all these factors are satisfactory, HUD will issue

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3. "Implied equity" equals 10 percent of total replacement cost. The mortgage equals 90 percent of total replacement cost. The term "implied equity" derives from the fact that the actual amount contributed by investors can be more or less than 10 percent of total replacement cost, but the 6 percent dividend is based on the implied equity. See p. 34.

4. See HUD Circular HPMA-FHA, 4442.3A, July 29, 1971, <u>Section 236 -- Developing Feasible Projects.</u>

5. If the regular income limits are not enough to make the project feasible, exception income limits (90 percent of Section 221(b)(3) limits) can sometimes be used. HUD area offices are reluctant to use exception limits but they do have the authority to apply them for part or all of a project. See HUD Circular FHA 4442.4, July 22, 1969.

a Feasibility Letter inviting the potential sponsor to submit an application for firm (conditional) commitment in accordance with basic project characteristics which are specified.[6] These include number and composition of units, estimated project income, maximum replacement cost, FHA land value, carrying and financing charges, construction budget (which includes builder's overhead and builder's and sponsor's profit and risk allowance), architect fees, and legal and organizational fees. The letter also specifies the maximum insurable mortgage, the estimated cash requirements at the close of the mortgage, and the amount of interest subsidy which has been reserved. The Feasibility Letter sets a time limit (60 to 90 days) for submittal of an application for firm (conditional) commitment.

The potential sponsor now instructs his architect to draw final plans. He also negotiates a firm price with his builder. He then applies for firm commitment by submitting a revised 2013 Form and related documents. These documents include Architect's Plans and Specifications, Land Survey and Surveyor's Certificate, and Architect's Errors and Omissions Insurance. The revised 2013 Form is based on firm prices instead of previous estimates. HUD charges a nonrefundable application fee which is $3 for each thousand dollars of the mortgage amount. This fee is covered by the mortgage when and if it is issued. If everything meets the proper specifications, HUD issues a firm commitment for mortgage insurance and the interest

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6. If the potential sponsor is inexperienced, HUD will ask him to apply for conditional commitment before applying for firm commitment. Conditional commitment is an additional stage which provides for further communication between the sponsor and the HUD area office before architectural drawings and negotiations with the contractor are finalized. Included among the tasks to be performed during conditional commitment are the preparation of preliminary architectural drawings, selection of and preliminary negotiations with a contractor, and revision of previously filed forms based on the new information.

subsidy. There are now a whole series of legal documents which must be prepared for initial close, at which point construction can begin. With firm commitment, the developer has completed the bulk of the development work prior to the start of construction. He has met HUD requirements, and HUD has legally bound itself to supply mortgage insurance and interest subsidy within specified limits. Without the FHA or some similar form of government subsidy, a feasible project in a poor community is almost impossible to bring to fruition.

Thus far I have described only FHA/HUD mortgage processing. In order to secure a firm commitment, there are a multitude of tasks to be performed which have not been discussed in any detail; these tasks require experience to perform well. For instance, assembling land at a cost that will permit low-income housing can be a major undertaking. It requires knowledge of federal programs such as urban renewal, which buys land and provides it at a minimum price to developers. If land acquisition is done privately, it requires a knowledge of techniques which will not unreasonably inflate the purchase price in assembling the numerous parcels which are usually required for a project. One must have the ability to make judgments, to negotiate, and to employ various technical skills. The developer coordinates the numerous elements. The success or failure of the project rests with him.

It is important to note that money must be spent even before there is any assurance that there will be a project. Options on land cost money, government agencies require fees for processing applications, architects must be paid for their plans, and housing consultants paid for feasibility studies. This initial outlay can account for 3 to 10 percent of the project.

A SAMPLE PROJECT

Table II. 1 presents a summary of project costs under a Section 236 limited-dividend project recently filed in an inner-city area. The plan calls for 160 units, 116 in a high rise structure and 44 town house units. The high rise structure contains 78 one-bedroom and 38 two-bedroom units. The town house units contain 12 two-bedroom, 20 three-bedroom, and 12 four-bedroom units. Table II. 1 abstracts the most significant line items from the 2013 Form.

Table II. 1 - Summary of Project Costs as Abstracted from FHA Form 2013

Line/Item no.	Description of projected costs	Dollars
36C	Total land improvements	$ 84,500
41	Total structure cost	2,147,100
42	General requirements	49,100
44	Builder's profit (waived)	--------
49	Fees (includes builder's overhead of $45,600)	156,200
50	Total improvements (sum: 36C, 41, 42, 49)	2,436,900
63	Carrying and financing	394,892
66	Legal and organizational	5,000
68	Builder's and sponsor's profit and risk allowance	283,679
69	Total development cost (sum: 50, 63, 66, 68)	3,120,471
70	Land	160,000
71	Total replacement cost	3,280,471
	FHA mortgage (90 percent of line 71)	$2,952,423

Builder's Overhead and Profit

According to the data in Table II. 2, the builder has told the developer that his total costs for construction of the 160 units will be \$2,280,700. This is the sum of line items 36C, "total land improvements"; 41, "total structure costs"; and 42, "general requirements."[7]

Table II. 2 - Builder's Profit as Abstracted from FHA Form 2013

Line item no.	Description of projected costs	Dollars
36C	Total land improvements	\$ 84,500
41	Total structure cost	2,147,100
42	General requirements	49,100
	Total costs related to construction	2,280,700
	Builder's overhead 2 percent	45,600
	Builder share of syndication profits	113,000

Together these three items represent the physical improvements in the project exclusive of fees, carrying charges, and builder's overhead and profit. It is on the basis of these items that the builder negotiates his profit. The builder has been given a 2 percent overhead allowance, which is included as line item 43 and comes out of the mortgage proceeds. In this case, the overhead is \$45,600. In addition to this overhead allowance, the builder has asked for a profit which is not included in the mortgage proceeds under the limited-dividend form of sponsorship. Therefore, the profit must be paid

7. "General requirements" refer to ancillary costs during construction, such as fencing around the project and a temporary trailer.

from the syndication proceeds of the developer.[8] The builder has asked for $113,000 fee, which is about 5 percent of the total physical improvement cost. If an Identity of Interest[9] is declared by the builder and sponsor, HUD allows what is known as a Builder's and Sponsor's[10] Profit and Risk Allowance (BSPRA). The BSPRA equals 10 percent of all project costs exclusive of land and BSPRA, which in this case is equivalent to $283,679.

Cash Requirement and BSPRA

Table II. 3 and Figure II. 1 show that in order to complete the project, the sponsor must contribute some cash, exclusive of any profit that he and the builder may obtain. Table II. 3 and Figure II. 1 present two methods of arriving at the amount of cash which is required from the developer. One key to understanding these methods is a firm grasp of the concept of BSPRA. The Builder's and Sponsor's Profit and Risk Allow-

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8. Syndication is the sale of an ownership interest in the project by the developer to high tax bracket individuals who receive a 6 percent cash dividend plus the right to use the losses of the project on their personal income tax return, thus reducing the amount of tax they have to pay. See pages 33 and 35 for further discussion.

9. Identity of Interest is never explicitly defined in HUD regulations, but it means that some form of business relationship exists between the mortgagor (developer and sponsor) and general contractor (builder). In FHA Form 2330, Mortgagor's Certificate of Actual Cost, some examples are given. These show that an Identity of Interest exists when a contractor (builder) takes stock or any interest in the mortgagor as part of the consideration paid to him, when there is any financial interest of the mortgagor in the contractor, or when one or more of the officers, directors, or stockholders of the mortgagor is also an officer, director, or stockholder of the contractor.

10. "Sponsor" is equivalent to "developer" as used in this paper.

ance (BSPRA), included as line item 68 on the 2013 form, can be pledged by the developer against cash requirements. It is not a cash item in the sense that all the other elements of total replacement cost are. The structure cost, the fees, and the carrying and financing cost must be paid if the building is to be built. The developer, however, does not have to pay the BSPRA because he would paying it to himself. This is why he can pledge it against cash requirements to reduce the amount of cash he must invest in the project.

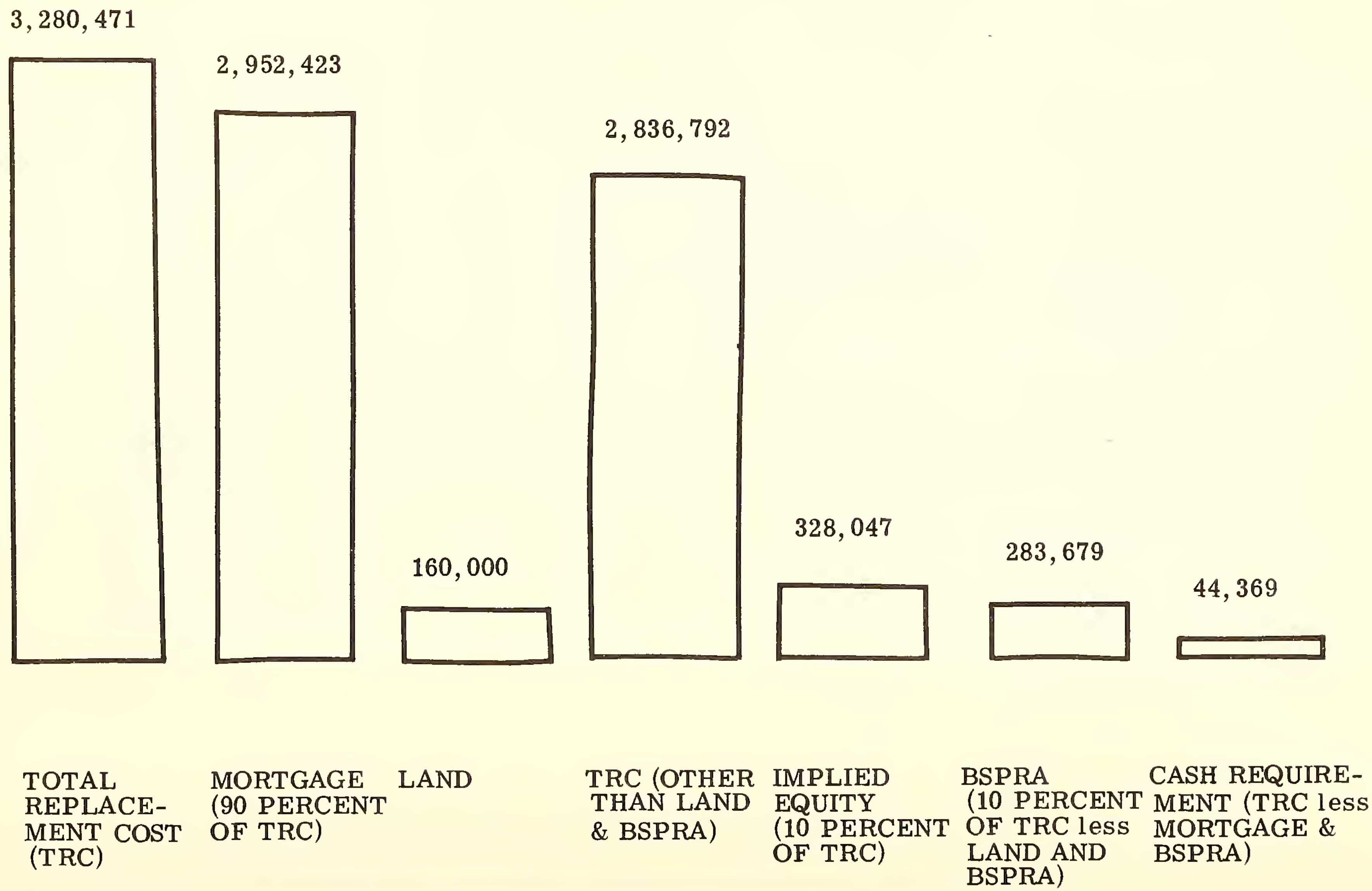
Table II. 3 - Cash Requirements as Abstracted from FHA Form 2013

Line item no.	Description of projected costs	Dollars
50	Total improvements	$2,436,900
63	Carrying and financing	394,892
66	Legal and organizational	5,000
70	Land	160,000
	Total cash costs to complete project	2,996,792
	Less FHA mortgage	2,952,423
83	Cash required from developer	44,369

The BSPRA is calculated by taking 10 percent of all project costs exclusive of land. Since BSPRA itself is included in total project cost, one must also exclude BSPRA when multiplying by 10 percent.

Figure II. 1 indicates that the cash requirement is $44,369. This was calculated by taking total replacement cost less the cash to be contributed by the mortgage less the BSPRA, the item in total replacement cost which is pledged against cash requirements.

Figure II. 1 - Constituent Cost Elements of an FHA 236 Limited-Dividend Project



In Table II. 3, the same figure is arrived at by adding all the cash items (BSPRA is not treated as a cash item) in total replacement cost and subtracting the amount of the mortgage to obtain the cash required from the developer or $44, 369. I have assumed that the 2 percent working capital requirement (2 percent of the mortgage) is supplied by a letter of credit. I have also excluded from current consideration the 15 percent net worth requirement (15 percent of capital contribution to the limited partnership) which is a rule of the Internal Revenue Service.

Tax Shelter Syndication

The developer must obtain the money necessary for the cash requirement, the builder's profit, and his own profit. These funds are obtained by forming a limited partnership and selling the tax shelter, a process known as syndication. The limited partnership usually includes the developer as general partner with limited partners who have made an investment in the partnership in return for an annual 6 percent cash dividend on the implied equity [11] and tax benefits obtainable from the accelerated depreciation allowed for housing. [12] The net syndication value of a new apartment development varies from 8 to 15 percent of the mortgage. [13] In this case, I have assumed a syndication value of 11. 7 percent of the mortgage. I have further

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11. Implied equity is equivalent to 10 percent of the Total Replacement Cost or $328, 047 in this case.

12. For a detailed description of the syndication process, see Morey and Epstein, Housing Development, pp. 21-41.

13. A low-income rehabilitation project can usually be syndicated for about 20 percent of the mortgage because of quicker depreciation allowed for such projects. Rehabilitation is considered to be a more risky investment than new construction. There tends to be a great variation in the percentage of the mortgage which will be invested. Many investors will offer no more than 10 percent to 12 percent of the mortgage.

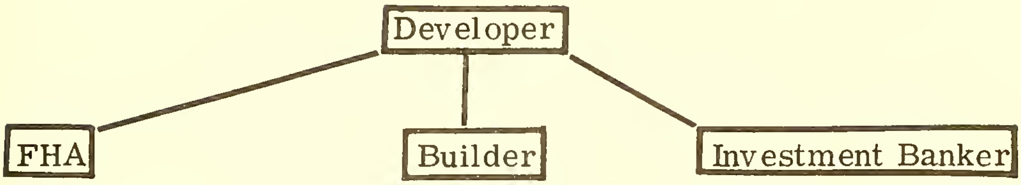
assumed that 99 percent has been sold to the limited partners with the general partner retaining 1 percent. Thus, 11.7 percent of the 99 percent of the mortgage is equivalent to $341,979. The developer must use this money to satisfy the cash requirements of the project as well as pay the builder his profit. After making these disbursements, the developer has a total profit of $184,610 (see Table II.4), which is 6.2 percent of the mortgage.

Table II.4 - Profitability Analysis
(assuming 11.7 percent syndication and sole developer-general partner)

Net syndication		$341,979
Disbursements		
Cash requirements of project	$ 44,369	
Profit to builder	$113,000	
		157,369
Total profit to developer		$184,610

The overall profitability and success of a project is dependent on the developer's ability to make satisfactory arrangements with three major parties: (1) the FHA, for mortgage insurance and interest subsidy; (2) the builder, for the amount he requires to construct the project and the share of syndication proceeds he wants as his profit, and (3) the investment banker, for the amount of money he is prepared to raise from limited partners as syndication proceeds to the developer. (See Figure II.2).

Figure II. 2 - CDC as Sole Developer



At the beginning of this paper, I described the FHA processing procedures and the elements which must be coordinated in order to obtain a firm commitment from the FHA. One element in this process that can have a significant effect on overall profitability is the amount the FHA allows for construction. The more the builder is allowed for construction, the more amenable he will be to accepting less from syndication proceeds as his profit. Under the limited-dividend form of sponsorship, the amount the builder receives as his profit is entirely negotiable. In our example, the builder receives 5 percent of structure cost from the proceeds of the syndication in addition to a 2 percent overhead allowance from the proceeds of the mortgage. Some builders will accept a fee of 3 percent of structure cost from syndication proceeds if they feel that there is enough money allocated to structure cost in the mortgage. In the example discussed above, the developer would have increased his profit by about $40,000 had the builder accepted 3 percent of structure cost as profit instead of 5 percent.

Changing the Structure of the Relationships

There are a number of ways to alter the profit picture by changing the structure of relationships between the developer, builder, and banker. I have used the term developer to mean the group that coordinates and takes ultimate responsibility for all the elements of a project. A community development corporation can play this role

alone or it can have a co-developer to help it. Usually this co-developer is the builder. Such an arrangement is presented in Figure II. 3.

Figure II. 3 - CDC as Co-Developer

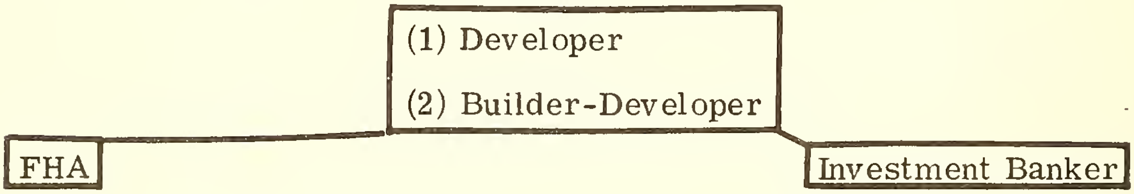
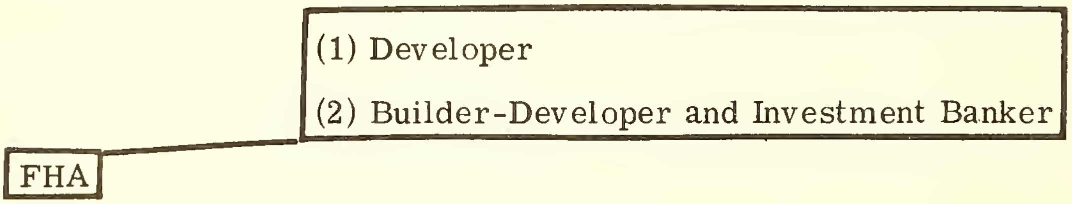


Figure II.4 illustrates a situation in which the builder-developer also functions as the investment banker. This means that in addition to performing the developer's and builder's roles, he also raises money from investors. The structural changes outlined in Figures II. 3 and II. 4 will have an effect on the developer's profit and on his rights and responsibilities in the limited partnership. The exact effect of these changes will be different in each situation, depending on the stature of the parties involved, their resources, their negotiating skill, and the syndication market at the time.

Figure II. 4 - CDC as Co-Developer and Investment Banker



Effect of Different Arrangements. In Table II. 5 I have assumed that the sole developer (of Table II. 4) has reconsidered and formed a joint venture with a builder-developer as in Figure II. 3. The agreement they have reached is to share the profits equally. The CDC has done all the work and spent the front

money to obtain a firm commitment from the FHA. This means that the CDC has obtained the land, hired an architect, and generally cleared the way in the local community for the project. The builder will build the project and act as advisor and as co-general partner in the limited partnership.

Table II. 5 - Profitability Analysis
(assuming 13. 8 percent syndication and builder-developer)

Net syndication (13. 8% of 99% of $2, 952, 423)		$403, 360
Cash requirements of project		44, 369
Total profit to co-developers		$358, 991
Profit to builder-developer (50%)	$179, 495	
Profit to CDC-developer (50%)	$179, 495	

The result is that the profit to the CDC is equivalent to the profit in the case in which it was sole general partner ($179, 495 vs. $184, 610). It is assumed that the stature of the builder-developer would result in greater net syndication proceeds (13. 8 percent instead of 11. 7 percent) and that the builder-developer would be willing to build for the 2 percent overhead from the mortgage plus his share of profits. This arrangement increases the builder's profit from $113, 000 (see Table II. 2) to $179, 495.

There is another advantage to a joint venture with an experienced, well-financed builder-developer. The Internal Revenue Service requires that a sole corporate general partner have a net worth of 15 percent of the capital contribution to the partnership. The interest in the limited partnership is excluded in this determination. This means that the CDC as sole general partner in this case would have to have

approximately \$50,000 from other sources,[14] \$15,000 for every \$100,000 invested by the limited partners. A builder-developer could offer the net worth to meet this requirement.

There is also a requirement for working capital equal to 2 percent of the mortgage. In the case under discussion, this would mean that the CDC would have to come up with \$59,000 at initial close. I have assumed that this requirement will be met by a letter of credit from a bank. A builder-developer would probably find it easier to obtain this letter of credit than would a CDC.

Thus far I have been speaking of net syndication proceeds. There are also gross proceeds, the amount the limited partners actually invest. This gross amount is usually reduced by 15 percent to arrive at net proceeds. The 15 percent is the cost of syndication; it includes lawyers' and accountants' fees for preparation of the private placement memo and limited-partnership agreement, and brokers' and investment bankers' fees. Sometimes a builder-developer is able to syndicate (as in Figure II.4) through his own channels at a cost of 10 percent instead of 15 percent. Table II. 6 indicates that with an identical mortgage, syndication at a cost of 10 percent of the amount invested instead of 15 percent results in additional proceeds to the general partners of \$22,000.

Table II. 6 - Comparison of Profits Possible at Syndication Costs of 10 and 15 Percent (assuming mortgage of \$2,952,423)

Gross syndication (15.15% of 99% of mortgage)		\$442,863		\$442,863
Syndication costs (at 10% and 15%)	at 10%	44,286	at 15%	66,429
Net before disbursements		398,577		376,434
Cash requirements of project		44,369		44,369
Total proceeds to General Partners		\$354,208		\$332,065

14. See Rev. Proc. 72-13, Internal Revenue Bulletin (1972-73), p. 26.

Another variation of the Figure II. 4 structure would be a situation in which a CDC has gained rights to land suitable for development through the local urban renewal process. This CDC does not have the funds or the expertise to act as developer. In return for contributing the land to a partnership and acting as co-general partner, the builder-developer might offer the CDC a fee of $100,000 payable at final close for a project with a mortgage of $3 million. The builder-developer would do all the development work and keep whatever profits it earned.

OTHER IMPORTANT CONSIDERATIONS

Thus far we have been concerned with the total amount of syndication proceeds and how these are distributed between the builder and developer. There are a number of other important issues in the syndication of a housing partnership which will be considered below. These are the phasing of syndication proceeds, management rights, coverage of cost overruns during construction and operating losses after construction, ownership of residual value, and other guarantees, escrows, or subordinations which might be requested.

Phasing

Investment bankers prefer to make their investment in a project as a series of payments rather than paying the whole amount at initial close. One standard payment procedure would be 1/3 of the syndication proceeds at initial close, 1/3 at 50 percent construction completion, and the remaining 1/3 at final close. A less favorable payment schedule from the point of view of the developer would be 1/3 at initial close, 1/3 at final close, and 1/3 one year after final close. An even less favorable schedule would tie the final payment to certain conditions being met, such as the project reaching a break-even level in terms of operating

costs. This condition increases the security of the investment for the passive investor. The payment terms are an item of negotiation between the developer and the investment banker.[15]

Phasing payments increases the rate of return to investors for a given investment. By agreeing to receive phased payments, a developer enables an investment banker to raise more money and offer the same return to investors than if all the payments were due at the start of construction.[16] On the other hand, a developer must consider his cash needs before agreeing to a phased payment schedule. He must determine whether the initial payment will cover the cash requirements of the project.[17] The increase in funds obtained from phasing usually justifies a loan for a year to cover cash needs until the final payments are received.[18]

Cost Overruns During Construction

A major risk from an investor's point of view is that the project will not be completed for the amount provided by the mortgage. Most investment bankers will request that construction cost overruns be covered by the local general partner, as is done in Section 2 of the standard National Housing Partnership Agreement. If a project runs into trouble, cost overruns can be significant, and most CDCs do not

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15. See Article 5. 2 (b) of the Limited Partnership Agreement.

16. In one case, phasing of payments at initial close, final close, and one year after final close would have enabled a CDC to raise 1/3 more money and to offer the same return that would have been offered if money had been paid at initial close. See Morey and Epstein, Housing Development, p. 39.

17. In the example discussed in Table II. 1, 1/3 of the syndication value or $113,000 would come in at initial close. This would cover the $44,000 cash requirement as well as the $60,000 working capital requirement.

18. See Morey and Epstein, Housing Development, p. 40.

have the resources to cover a major overrun. This is one reason why many bankers will not accept a CDC as sole general partner.

One way of protecting against overruns is to require the builder to obtain a 100 percent bond. Even such a bond is not full protection. If a builder fails after 50 percent of the work had been completed, the bonding company will provide the remaining 50 percent. However, it usually requires more than the remaining 50 percent to bring in a new builder to complete the job. Also, a bond does not cover carrying costs above the budgeted amount which might be caused by delays in construction due to a strike.

One way for a CDC to handle cost overruns is to get a large builder to agree to a fixed-price contract which means that if it costs more to do the specified work than the builder expected, he will do the work at his own expense. The builder would not be responsible for changes from the original plan. In return, the builder would ask for a greater profit. The fixed-price contract and bonding requirements tend to make it harder for a CDC to use a minority-owned building firm. These firms generally have difficulty obtaining a bond and do not have adequate resources to cover overruns.

Management

Once the housing is completed, most CDCs would prefer to manage the property or designate a local management group to manage it for them. While most investment bankers will agree to such an arrangement, they usually make it conditional. For instance, the National Housing Partnership (NHP) reserves the right to remove the local general partner as manager of the project at any time it chooses. There is no limit on this right. In practice, the NHP has no incentive to do this unless the project is losing money. Nevertheless, many CDCs would prefer to place a limit on the right of the limited partners or co-general partner to remove them from management. One way of doing this is to specify the level of operating losses as the trigger for removal. A CDC might place a portion of its syndication proceeds in

escrow to cover these losses.

Another arrangement is to have a well-known management agent take responsibility for the management with the intent of subcontracting the job to a local management group acceptable to the CDC. Some investment bankers are willing to go along with this arrangement, because they feel that the well-known management company is putting its reputation on the line.

Subordination of Management Fee

In order to increase the likelihood that an investor will receive the 6 percent dividend, some investment bankers ask that the management fee be subordinated to the dividend payment. This means that in a given year if there is not enough money from operations to pay both the management fee and the dividend, only the dividend will be paid. Some bankers will allow 40 percent of the management fee to be paid with the remainder to go toward the 6 percent dividend.

Operating Deficits

The second major risk to an investor is that, once completed, the project will run deficits so large that it will eventually fall into foreclosure. Investment bankers might ask the CDC to establish an escrow fund to cover any deficits. If it becomes necessary to use such funds, the CDC can agree to use them out of escrow in the form of a loan to be repaid out of any future surplus, or alternatively the funds could be used in such a manner that the CDC will have no further rights to them.

A co-general partner might agree to support operating deficits in the form of a loan if the CDC has also placed in escrow part of its proceeds to cover such deficits. As is the case with construction cost overruns, the potential for operating deficits makes investment bankers reluctant to invest in a project that does not include a financially strong partner.

A unique feature of the deal that the National Housing Partnership offers developers is that NHP will cover operating deficits to the extent of its ownership interest in the project. This interest can be as much as 95 to 99 percent. Such a commitment on the part of NHP virtually assures the life of the project. This is a very strong part of the NHP offer in view of the fact that some investment bankers are reluctant to invest in inner-city projects.

Residual Value

Part of the negotiation process is to determine who will own the project when the limited partners want to sell at some date in the future when they receive the bulk of the tax benefits. Many investment bankers do not consider residual ownership an important factor. Others, such as the National Housing Partnership, prefer to have the same proportion of residual ownership that they had upon initial investment. Still others tend to prefer a 50/50 split of the residual value.

Although the National Housing Partnership prefers to maintain full ownership, it does provide a clause which allows a cooperative formed by the tenants to buy the project for the outstanding mortgage plus the original capital contribution of the limited partners. The tenants can take this option at any time after the initial close.

The ability of a tenant group to buy a project is dependent upon its ability to arrange financing. Financing is available under Section 236(j) of the Housing and Urban Development Act of 1968, which authorizes HUD to insure a mortgage loan for 100 percent of the purchase price in a transfer from a private owner to a nonprofit corporation or a tenant cooperative. The new mortgage can get as much as 100 percent of original, HUD approved, project replacement cost if the appraisal justifies such a price. In such a sale an investor can usually recover his original investment after paying taxes on the sale.

The change in proportion of ownership by the general partner and the limited partners from the usual 5 to 95 percent split can be specified

in the partnership agreement in two ways, through a flip-flop or a sale. A flip-flop means that at some specified point the interest of the limited partners will be reduced from 95 percent to some lesser amount, while the interest of the general partner is increased from 5 percent to an amount greater than that held by the limited partners. The changeover can be made when the limited partners have recouped their cash investment or 20 years after final endorsement, whichever is sooner. Some lawyers feel that the changeover should never be more than 50-50, while others allow a 70-30 or greater changeover in favor of the community group (general partner). The consideration here is that from the point of view of the Internal Revenue Service it must look like the investors are making a legitimate investment which means economic benefits from the project other than the tax benefits. The more extreme the degree of flip-flop, that is, the less the limited partners end up owning, the more likely it will be that the IRS will take the view that there was no legitimate investment and that the investors are not entitled to the tax benefits. One should act on the advice of a tax lawyer before making any flip-flop arrangement.

There is some question as to whether a sale can be specified in the partnership agreement without jeopardizing the ability of investors to utilize the tax shelter. Conservative tax counsel would tend to advise that no specification of a sale should be put in the partnership agreement. They would argue that such a provision would mean that limited partners never really owned the project and, therefore, are not entitled to the tax benefits. Less conservative counsel would say that whether a specification of sale nullifies the tax benefits is dependent on the nature of the specification. For instance, less conservative counsel might say that an option 20 years from now could be inserted into the agreement, if it is at a "reasonable" price. Many CDCs place a high value on the ability to own a project after 20 years. Tax advice must be sought, however, before formalizing the sale in the partnership agreement.

National Housing Partnerships

The NHP is chartered under a 1968 Housing Act to invest in limited-dividend housing projects. It has become a major force in the investment banking market for low- and moderate-income projects. The NHP has three basic arrangements (known as Mark 1, 2, and 3) that it will make with local developers.

Under its Mark 1 arrangement, the NHP will take anywhere from a 25 to 99 percent interest in a project. Usually 1 percent of this interest is in a general partnership position with the remainder as a limited partner. NHP tends to value projects at between 9 and 11 percent of the mortgage. While this is somewhat less than other investment bankers offer, NHP tends to invest in inner-city areas and covers operating deficits to the extent of its ownership interest. Other bankers are reluctant to invest in inner-city areas, and most will not cover operating deficits. A basic part of NHP's arrangement, however, is the right to take over management whenever it decides it is necessary.

A community group, with whom the author has consulted was recently offered 11.25 percent of the mortgage by NHP under its Mark 1 arrangement. NHP wanted a guarantee that construction would be completed. No one connected with the project was willing to give such a guarantee. Short of a guarantee NHP wanted to postpone syndication payments to the community group until construction was completed. NHP would pay out of syndication proceeds the cash requirements at initial close and 17 percent of the syndication proceeds to the builder at 50 percent completion. The remainder would be paid to the community group at final close.

There is a competing offer from a private banker for 13.8 percent of the mortgage. The banker would pay 30 percent of the proceeds at initial close, 40 percent when construction is 50 percent complete, and 30 percent when the building reaches 90 percent occupancy. Both offers are still under consideration.

The NHP Mark 2 arrangement is the same as the Mark 1 except that NHP also offers to make a seed money loan. This seed money loan

is at 2 percent above prime and is repayable at initial close. It is offered for use between the time a group obtains a feasibility letter and initial close. It can be used for optioning or purchasing land, architectural drawings, and test borings. NHP might discount the syndication valuation about 1 percent to take account of the fact that it has offered a seed money loan.

The Mark 3 arrangement is one in which NHP will act as general partner and developer of a project. It is suitable for those nonprofit groups that have neither the money nor the expertise to do housing development. In return for handling relationships with the local community, NHP might offer the local group a fee of 1 percent of mortgage or 1/2 of the 6 percent cash flow for 10 years. The Mark 3 arrangement does not offer a local group much of a share in profits, but it does get housing built in their community. If such a group gains expertise in the process, it could probably make a more favorable joint venture arrangement on its next project.

CONCLUSION

A community development corporation has some basic options when packaging a limited-dividend project under Section 236 of the National Housing Act. They involve the choice and structuring of a legal and financial relationship with a builder, co-developer, and investment banker. There is no formula which can be applied to the details of the kinds of relationships which can be structured and their financial implications, but the figures presented here are based on real cases. They reflect attitudes held by the financial community with reference to tax shelter investment in low-income housing. For instance, we found that when a community group brings in a builder as co-developer who has financial means and experience in housing, some investment bankers would usually be willing to place a higher investment value on the project than if the CDC acted as sole developer. Bringing in the builder as co-developer means you have to give him a greater share of the profits. In the case presented in the paper, this resulted in the

same profit to the CDC as when the CDC was acting as sole developer, because the total profit to be shared was greater.

Within certain value parameters discussed in the paper, the final terms of a deal which a CDC can structure is dependent on the needs and the negotiating skill of the parties involved.

Section III

A Limited-Partnership Agreement

INTRODUCTION

This section of the paper presents an annotated limited-partnership agreement for real estate development investments. It will be assumed that the reader is familiar with the limited-dividend approach to financing government subsidized housing as it is explained in Section I, "Limited-Dividend Sponsorship." Further, the discussion presupposes a knowledge of how the legal entity known as the Limited Partnership can uniquely meet the needs of local groups interested in housing and of outside investors interested in a potentially high return on their money. However, a quick review at this point of some of the more central elements of partnerships will aid in understanding this annotated agreement.

Community and Investor Objectives

Community groups in all parts of the country are interested in controlling the development that takes place in their neighborhood. Among other objectives they want a determinative role in deciding what kinds of housing are constructed and where. They often want a strong say on the operational policies of the management. They may also wish to have ultimate ownership of the buildings. Further, they would like to receive a portion of the profit made in housing. The community's share of the "profit" may be taken in improvements to the housing or in cash to be invested in other neighborhood projects. As Section I explained, nonprofit sponsorship can give power to the community, but it cannot arrange for a profit. Only a form of sponsorship that makes use of the special housing depreciation provisions of the federal tax law can generate profits. As we have seen, tax deductions for depreciation produce tax losses, and the owner of a building is entitled to use these depreciation generated losses to offset his taxable income from other sources. A high income, high tax bracket investor will be interested in an investment in which part of the expected return is in the form of tax savings.

Tax Attributes of a Partnership

If a limited partnership can uniquely meet the needs of community groups and investors, the first question to ask is what the attributes of such a partnership are. The most important characteristic in this context is the partnership's ability to "pass through" income and losses to the partners. A partnership is not a taxable entity the way a corporation is. If a partnership realizes either a profit or a loss, such profit or loss is divided among the partners. For instance, if A and B each have a 50 percent interest in a partnership and the partnership realizes a loss of $100,000, each partner would be entitled to deduct $50,000 on his personal income tax form. These deductions are valuable, as over the years they add up to more than the amount of the original investment. This is true because each partner may deduct losses up to the amount of his "basis" in the partnership. His "basis" is defined as the sum of the money he has invested plus his share of the liabilities of the partnership (the mortgage). An equity investment of $200,000 may be leveraged into a building with a $2,000,000 mortgage. Thus, there might be almost $2,000,000 of potential losses (depending on the cost of the non-depreciable non-expensable assets) that would offset taxes otherwise payable on income from the project and from other sources. Secondly, there is great flexibility for determining which of the partners will get what portion of the partnership profit or losses, and the Internal Revenue Service will generally accept any reasonable allocation based on some defensible and real financial aspects of the arrangement between the partners.

Corporate Attributes

Corporations, unlike partnerships, are taxable as independent entities. If a corporation owns property, it may use any depreciation generated tax losses to offset any other income earned by the corporation. The tax liability of a stockholder is not affected at all, while the stockholder continues to hold the stock. When the stockholder sells his stock

in some later year, he may realize a gain or loss. However, any loss is a capital loss which cannot in general directly offset ordinary income. Thus, the corporate form defeats one of the major investor objectives -- the realization of immediate tax savings as part of the benefit stream flowing from the investment. Thus, it is imperative that the legal entity that owns the property be taxed as a partnership rather than as a corporation.

General Partnerships, Limited Partnerships

We have already seen the necessity for a form of ownership that will be taxed as a partnership. However, a general partnership has one severe limitation from the point of view of an investor. A person making a decision to invest $100,000 of his capital in a project hopes to make a profit but wants to be assured that if the worst happens, he will not lose more than the original $100,000 he deliberately put at risk. This person will not invest in a partnership where each partner is liable for all the debts of the partnership. If the debts are high and the other partners have limited outside resources, he may end up losing considerably more than his original investment. Such a person might be interested in a limited partnership. In such an arrangement, there are two kinds of partners: general partners, who at least theoretically remain subject to the usual rule of unlimited liability for corporate debts, and limited partners, whose liability is limited to their initial investment. To be classified as a limited partner, an investor is generally required by state laws not to participate in the day to day operation of the project. This requirement suits community groups, since they, as general partners, are left free to manage the project. In practice, of course, the limited partners exert a great deal of indirect control by setting certain limits on management decisions in the partnership agreement itself. However, this change in the usual partnership arrangement (where all partners join in management) raises the tax problem anew. Is the partnership with centralized management still a partnership, or is it more like a corporation (with

limited partners in the role of stockholders) and thus to be taxed as a corporation?

Substance Versus Form

In general, the Internal Revenue Service wants to tax like entities alike and is suspicious of hybrid entities which call themselves one thing but have attributes of something else. The Regulations of the Internal Revenue Service list four characteristics which distinguish corporations from partnerships. (See IRS Reg. Section 301.7701-2.) The characteristics of a corporation are:

1. Centralization of Management;
2. Free Transferability of Interests;
3. Continuity of Life;
4. Limited Liability.

If a limited partnership avoids two of these characteristics, it is likely to avoid corporate tax status.

1. Centralization of Management. Centralization of management exists if "substantially all" the interests in the partnership are owned by limited partners. In most cases where a community group is a general partner, its interest will be small (1 to 5 percent). Unless these is a co-developer general partner with a substantial interest (probably exceeding 20 to 30 percent) it is probable that the IRS will find enough split between ownership and management to declare that centralization of management exists.

2. Free Transferability of Interests. In general, corporate stockholders may sell their stock to any buyer without consulting anyone. This is free transferability of interests. Partnerships generally require that the partners agree before a new partner can be substituted for an old one. It is very easy for a limited partnership to put in restrictions forbidding substitution of one unlimited partner for another without the consent of the other partners. See Article 10 of the Partnership Agreement. This, then, is one corporate attribute that is easily avoided.

3. Continuity for Life. Corporations continue whether or not any particular stockholder dies, goes bankrupt, or otherwise cannot exercise control over his stock. Partnerships usually formally dissolve under state law if one partner dies or is otherwise incapable of continuing in the partner role, although in fact partnerships generally provide that the remaining partners will carry on the "new" partnership without any interruption. If limited partnerships were dissolved by the removal of a general partner, financial disaster might result. Thus, all limited partnerships make some provision for replacing the general partner and carrying on the project. The factor determining whether or not there is continuity of life for tax purposes is not whether the partnership agreement provides for the partnership to carry on, but whether state law provides, despite the agreement, that any member may call for dissolution when a general partner is changed. (See IRS Reg. Section 301.7701-2(b).) Thus, in states where the Uniform Limited Partnership Act or its equivalent is not in effect there should be no problem in avoiding continuity of life. In other states noncontinuity clauses must be carefully drawn. (See Partnership Agreement, Article 10.) Limiting the life of the partnership to a set number of years does not destroy continuity of life.

4. Limited Liability. As we have seen, the main reason for limited partnerships is that limited partners have limited liability. This does not mean that the partnership as a whole has limited liability. It is sufficient to avoid the corporate-like attribute of limited liability if one partner, a general partner, has unlimited liability. However, the IRS looks to see if the general partner is more than theoretically liable. If in fact his assets outside the partnership are vary small in comparison to the size of the investment in the project, no debtors could ever hope to collect in a suit against him. He is "judgment proof." Thus, a "substantial assets" test has been promulgated by the IRS. In cases where the general partner is an individual and acts independently of the limited partners instead of as their agent, it is likely that this test can be passed. However, the IRS has recently

promulgated Revenue Procedure 72-13 [1] which applies strict rules in cases where the general partners are all corporations. This ruling provides, in part, that if the total contributions to the partnership are less than $2.5 million, then at all times during the life of the partnership the general partners must have an aggregate net worth (exclusive of any partnership interests) of 15 percent of the capital contribution to the partnership or $250,000, whichever is the lesser. Thus, the IRS will not provide an advance letter to the partnership (before construction begins) that states that the business association will be treated as a partnership for tax purposes, unless their criteria are met. (Of course, the partnership must meet the other criteria of partnerships as well.) The lack of such an IRS determination letter will be fatal to the project, as no outside investors will come in without IRS assurances that the expected tax benefits will materialize. Indeed, the IRS puts great emphasis on this fourth characteristic. Even if it should later turn out (at tax audit time) that the limited partnership was entitled to partnership taxation status because it lacked corporate characteristics (2) and (3), this would do the partnership little good.

It is ironic that the IRS puts such stress on the assets of the general partners, because in fact limited partnerships in the housing development area (and several other areas) are carefully constructed (for other tax reasons) to effectively limit the potential liability of the general partner.[2] The IRS is fully aware of this practice and, in fact,

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1. Rev. Proc. 72-13, 1972-2, I. R. B. 26.

2. Real estate partnerships always arrange for the mortgage and loan agreement to provide that neither the partnership nor the partners be personally liable for the debt on the property. The lender must agree that the property alone be security for the loan. This means that if the loan is in default, the bank may take title to the property and sell it, but, if the amount realized at the sale does not cover the entire loan, the partnership may not be sued for the remaining debt. As has already been explained, the partner's share of the partnership's debt increases his "basis" (and potential tax deductions). But a limited partner, by definition, has no such "share." Therefore, the IRS provides that where no partner has any personal liability for a partnership debt, partners -- including limited partners -- will be treated as sharing such liability. Their share will equal their proportion of the profits.

created the fiction that encourages this practice. Substance does not always win out over form in the tax law.

Other Partnership Tax Considerations

Potential investors will not only be concerned that the partnership meet the IRS criteria for partnership tax status. Other aspects of the agreement will affect whether they will achieve their goal of tax benefits. These include:

1. Allocation of Annual Benefits;
2. Allocation of Residual Benefits;
3. Terms of Sale.

1. Allocation of Annual Benefits. As mentioned earlier, the IRS looks for some congruence between the amount of the benefits to be derived from the partnership by a particular partner and the amount put at risk by that partner. Thus, the annual limited dividend allowed by the FHA ought ordinarily to go to the partners in the same proportion as their ownership interests (though this is not always done).

2. Allocation of Residual Benefits. The general partners usually bargain for the rights to an increased residual interest in the building after a given number of years. Thus, most partnership agreements will initially give most (up to 99 percent) of the right to partnership gains and losses to the limited investors. This is because the partnership expects tax losses in the early years, and the more tax losses the limited partners are entitled to the more they will pay to join the partnership. However, in order for the limited investors to have the right to 99 percent of the losses, they must own close to 99 percent of the building itself. For instance, the IRS will question why the limited partners are entitled to 99 percent of the gains and losses if they are only 50 percent owners of the building. As time goes on, however, the depreciation deduction decreases, the tax losses end, and there will probably be taxable profits. At this point the investors will not want to be entitled to 90-99 percent of the profits, and they will ordinarily be willing to agree to a different split. (See Article 11 which provides

for a switch in percentages on a preset conversion date). This is known as a "flip-flop," and the tax consequences must be carefully considered. For example, a clause which provides for a "flip-flop" just at the point that the partnership begins to have taxable income would highlight the tax shelter aspects of the investment. The IRS will not countenance outright and blatant "sale of tax losses." [3]

3. Terms of Sale. Another clause that may raise tax questions is one that requires the limited partners to sell at a predetermined price to the tenants after a given number of years. The Internal Revenue Service will argue that the limited partners never really owned the project and were thus not entitled to take depreciation at all. Though this means that the tenants should have had the right to take the depreciation, the low-income tenants would not be able to use such deductions. It is for this reason that Article 13, "Sale of Assets," is left blank, and groups are especially urged to consult an attorney on this question.

If the community group wants to insist on some sort of sale provision, tax concerns arise in still other ways. Let us assume that the community group wants to be able to sell the housing units to the tenants as soon as possible. First, the limited partners will insist that no sale take place while there are substantial tax losses available. For government subsidized rehabilitation projects, this will take 5 years; for subsidized new construction, somewhat longer. Further, they will want to avoid a sale until the IRS can no longer "recapture" the tax deductions they have already taken. Ordinarily, when real property held for investment is sold, the gain on the sale is taxable as capital gains (with a lower tax rate than on ordinary earned income). But when the seller takes accelerated depreciation, the gain, to the extent of the "excess depreciation," is taxable at ordinary rates, and this is known as recapture. However, the tax law provides for a gradual decrease in

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3. Actually, real estate syndication is an outright sale of losses that would not be countenanced in, say, a sale of operating losses in a manufacturing venture. Perhaps it it more accurate to say that the IRS allows a simple outright sale of losses as long as you don't try to gild the lily.

the amount of recapture the longer the building is held. Thus, with government subsidized housing there is no recapture after a period of about 16 2/3 years for rehabs and 10 years for new construction.

One possible way to sell to tenants while there is still the threat of recapture is to take advantage of the "rollover" provisions in the IRS Code (Section 1039). To simplify a bit, the provisions of this Section of the Code allow the owner to postpone any taxes due upon sale of the property financed under Section 221(d) or 236 of the National Housing Act if the owner (1) sells it for a price at or below the statutory maximum with FHA approval to the tenants or to a qualified nonprofit tenant group, and (2) constructs an equivalent qualified project within a year of the sale. All taxes are then postponed until the sale of the second project. Further, the years the second project is held are added on to the years the first project was held in determining whether there will be any recapture of accelerated depreciation taken on the first project. Thus, some taxes at ordinary rates may be avoided. Since taxes are less, the investor can presumably sell to the tenants for a lower price. A written clause providing for a sale to tenants, if conditions are such that the rollover provisions will apply, should not threaten the tax status of the deal. The IRS is not likely to claim that the tenants owned the building all along. This is because a rollover clause will almost certainly be drafted as a contingency clause. The limited partners cannot be sure they will be able to find an equivalent project. The tax laws may have changed in the meantime. Further, there is some question as to whether an investor would actually benefit from using this tax postponement provision. It is not clear whether it would not be better for an investor to build a succession of subsidized buildings and hold each until there was no longer a threat of recapture rather than build one structure, sell to the tenants using the rollover section and build a second (and third, and so on) structure. Because of these factors and others, Section 1039 is not used as much as the drafters expected it to be.

Community Concerns

We have so far been concentrating on how to reach the tax goals of the investor. The community group also has tax concerns and other legal concerns. This section of the paper will not concentrate on helping the community group protect its substantive interests. The footnotes to the partnership agreement as well as the other two sections of the paper contain sufficient suggestions of what should concern a community group in the negotiating process. However, most community groups assume that they needn't be bothered by any tax issue that relates solely to themselves. This is because community groups are in general tax-exempt organizations. However, the annotated agreement presented here assumes that the community group wishing to enter the housing field established a separate entity (either a for-profit or nonprofit corporation) to act as a local general partner. It is this separate legal entity which enters into partnership with the outside investors (and perhaps the developer). A separate entity is set up to prevent the possible bankruptcy of the housing project from also bankrupting the neighborhood organization. It is further assumed that this entity will be subject to federal and state taxes (even corporations classified as nonprofit under state law are taxable if they do not apply and qualify for federal tax exemption); that is, the money the local general partner receives will be taxable. Thus, the taxes payable must be subtracted from the expected returns. This also means that the community group will be interested in making its profits on the project in a way that will be taxed at capital gains rates. It may, for instance, be possible to arrange for a profit to be made on a sale of land, held by the community group or local general partner, to the partnership in such a way as to result in capital gains. On the other hand, payments to the local general partner for development work would be ordinary income.

If the separate housing entity were put together as an organization which was exempt from federal taxes, it could clearly return a larger amount of money to the community group. However, there are serious

problems connected with a tax-exempt organization doing housing development. It is possible that the tax exemption could be lost altogether or that the organization could be treated as a private foundation (IRS Code Section 509(a)) by the IRS, which would mean onerous accounting and reporting requirements as well as restrictions on certain transactions (IRS Code Sections 4940-4945). These same problems could arise when a tax-exempt community group set up a taxable housing subsidiary if the receipts from housing development became a large enough percentage of its total receipts. For further information on some of these important tax problems, nonprofit groups might contact Michael Smith at the National Housing and Economic Development Law Project, Berkeley, California.

Use of the Annotated Agreement

This annotated agreement is not meant to be used directly as a legal document. No group should feel that it does not need, at least, a housing consultant and legal and accounting help in this field. Although this paper should help community group negotiators right from the start, the final written agreement should be drafted by a lawyer. Good accounting advice is also essential. This annotated agreement should be especially helpful to groups whose legal counsel is not expert in housing development. Such counsel will find this "model" a good starting point whether in drafting a document, or, as will more likely be the case, in judging one presented by counsel for the syndicator-broker or counsel for the developer.

In most cases, a limited partnership agreement is not drawn up until a syndicator-broker has agreed to take on the transaction. Many brokers have standard agreements that they have used in the past and with which their "stable" of investors is also familiar. Therefore, they will urge the general partners to accept their standard format. Some brokers will be willing to consider a community-prepared document and more will be willing to make some changes in their standard agreements.

The agreement itself (as a model of a possible legal document) will be most useful to community groups that have decided on an approximately equal joint venture development or at least on an approach where the group performs some development functions. In particular, the transaction that is embodied in this agreement is one for new residential housing construction financed through FHA. However, the annotations are meant to help the housing director and legal counsel of a community group adapt this model to meet the actual local situation. A group that has decided to be the sole developer of a project will be able to ignore all sections that specify the relationship between the general partners (Article 7), but will find useful the sections that spell out the relationship between the general partners and the limited partners (Article 6).

If a community group is interested in a more limited role in any given housing project, this annotated agreement will not be directly usable as the basis for a legal instrument. However, the annotations may still prove valuable to such a group in its bargaining with the developer. As already stated, the annotations are meant to give the reader a feel for the various aspects of housing development and construction so that a community group can be a more aware bargainer. For instance, it is important to know that a large contractor can often do a lot of its own subcontracting and thus make the 15 percent profit allowance for subcontractors that is built into the mortgage. Knowing this fact, the community group can bargain more realistically with a developer/contractor who points to the low builder overhead allowance of FHA as a reason for taking the lion's share of any syndication proceeds.

Joint Venture Agreement

In at least one respect this agreement is peculiar in that it contains articles that will not be found in a standard partnership agreement with limited partners: articles such as "7.1(a) and (c)," "8.2 Syndicator," "8.6 General Contractor," "8.7 Architects," These articles are

more appropriate to a joint venture agreement between the local general partner and the developer rather than the agreement that is drawn up between the general partners and the investors. Scenario B in Section I of this paper presents such a joint venture agreement. A joint venture agreement is usually drawn up when there is to be more than one general partner or when the building contractor is to do some part of the development work in one form or another before a limited partnership agreement is completed. In fact, a joint venture agreement might be drawn before any real work begins, when plans are still a little vague and perhaps even the particular sites have not yet all been acquired. Thus, such an agreement would need to describe explicitly, for instance, how an architect or syndicator will be chosen, who will be responsible for getting mortgage commitments, or how a builder will be chosen. A limited-partnership agreement is not ordinarily drawn up until construction has begun or is imminent. At that point in time, the limited partners do not need to be concerned with such questions as how an architect will be selected.

This annotated agreement, however, contains such "joint venture articles" because the local general partner will often need to be concerned with such decisions. Scenario B presents an actual joint venture agreement and not a summary of a more detailed agreement. The agreement is almost totally concerned with the roles that the CDC and PDC will play and how they will split the available profits under the mortgage and from syndication between them. The structure of the deal between the joint venturers and the potential investors is not even mentioned. This is because the agreement is being made so early in the construction game that it is impossible to tell what will be a salable deal when the plans are ready for implementation.

One last word of warning might be appropriate at this point. This annotation will not be easy reading the first time through, and it is important to pay particular attention to the footnotes which contain much of the necessary explanation of the body of the document.

Contents

LIMITED-PARTNERSHIP AGREEMENT

1. PARTIES

1.1 Formation of Partnership. This limited partnership is formed under the laws[1] of ______________________________ between the General Partners[2] and the Limited Partners, whose names and addresses are set out in Schedule A attached hereto and by this reference incorporated herein. The term "Partners" in this Agreement shall refer to both General and Limited Partners.

2. NAME AND ADDRESS

2.1 Name. The name of the limited partnership shall be __________ ____________,[3] which shall be referred to hereafter as "the Partnership."

2.2 Address. The principal place of business of the Partnership shall be located at ____________________________________ and such other places as the General Partners shall designate by notice to the Limited Partners.[4]

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1. It would probably be a good idea to state the exact section of the particular state law relied on. For example, in Massachusetts it is Chapter 109 of the Massachusetts General Laws.

2. This agreement assumes that the community group and the developer will both be general partners. It is possible for a community group to be sole general partner as was done by the Roxbury Action Program (RAP) in Boston.

3. State law should be consulted in case there is some regulation of the names of real estate partnerships.

4. Generally, state law will require that the principal place of business be located within the particular state where the Project is located. State law should be consulted for requirements in designating more than one address.

3. PURPOSE

3.1 Provision of Low- and Moderate-Income Housing. The Partnership is organized exclusively to provide housing facilities and such social, recreational, commercial, and communal facilities as may be incidental or appurtenant thereto to persons of low- and moderate-income in the single housing project herein described. [5] The Partnership shall achieve such exclusive purpose by (a) acquiring certain land described in Schedule B attached hereto and by this reference incorporated herein, (b) owning, developing, constructing, operating, and managing thereon a certain housing project (the "Project"), (c) acquiring other real or personal property which may be necessary, convenient, or incidental to the accomplishment of the purposes described in this section, (d) financing the Project under an appropriate section of the National Housing Act [6] administered by the Federal Housing Administration (the "FHA") or any successor entity.

4. TERM

4.1 Commencement of Partnership. The Partnership shall commence upon the date its partnership certificate [7] is filed in the

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5. The particular project of a given community group may be described in more exact detail at this point, and may include details such as number of units, size of units, etc.

6. This agreement assumes that FHA financing is to be used. For any particular project you would describe more fully your financing arrangement (e.g., cite section of statute) with FHA or other government agency (e.g., Massachusetts Housing Development Authority). If FHA financing is used, it is a good idea to state that the land is the same land that will be subject to the FHA mortgage commitment for project # (FHA assigned number).

7. It is not uncommon to backdate these agreements to the day construction began if the partnership is formed at a later date. The advantage is that the Limited Partners can attempt to use construction expenses incurred before the certificate is filed. The problem is that this might result in the assumption of some partnership liabilities that arose before the partnership was on top of the problems.

Office of the ______________________ County Clerk, [8] which filing shall occur as soon as possible after this agreement has been executed by the General Partners and one or more Limited Partners and shall continue for a term of 50 years [9] thereafter.

4.2 Dissolution. The Partnership shall be dissolved prior to the expiration of the term on the date of the occurrence of any of the following events:

(a) The date on which the General Partners file an election to dissolve the Partnership, after the decision of both of the General Partners and 75 percent of the Limited Partners to terminate the Partnership. [10]

(b) The withdrawal or removal of all the General Partners and the failure to elect a Substitute General Partner pursuant to Article 9.3 so that there are no General Partners in the Partnership.

(c) The voluntary or involuntary sale of substantially all of the assets of the Partnership. [11]

4.3 Death of a Limited Partner. The death of a Limited Partner shall not dissolve the Partnership nor terminate the Partnership business.

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8. This required filing may have a different name in your state such as "Certificate of Limited Partnership" in California. In California the certificate is filed in the office of the appropriate County Recorder instead of County Clerk. In Massachusetts a sworn certificate shall be filed with the Secretary of the Commonwealth. Check state law for local filing requirements.

9. This is to some degree an arbitrary number. FHA will require that the term exceed the number of years necessary to pay off the mortgage. Although in most states a partnership need not explicitly limit its life, a time limitation is usually placed on the partnership in order that the IRS should treat the association as a partnership for tax purposes and not as a corporation. However, see Introduction to Section III, under "Substance Versus Form."

10. The percentage of Limited Partners needed for dissolution is somewhat arbitrary.

11. Check state law for any other situations requiring dissolution. There may be other dissolution clauses; for instance, when the assets are transferred to a new partnership. "Assets" in this context refers to tangible assets such as real estate.

5. CAPITAL

5.1 Capital Contribution of General Partners. The initial contribution of ______________________, (the "Local General Partner")[12] shall be ______________________.[13] The initial contribution of ______________________, (the "Developer")[14] shall be ______________________.[15]

5.2 Capital Contributions of Limited Partners.

(a) Each person who executes this Agreement as a Limited Partner shall contribute to the capital of the partnership $________[16] in cash for each of the Limited Partnership Units set forth opposite his name on Schedule A. The total number of Limited Partnership

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12 . The community group will be called the local general partner wherever it is necessary to distinguish between the two general partners.

13 . Any contribution to be made by the community group should be listed here or in a separate schedule which would be incorporated by reference. This may include such items as land (more usually sold to the partnership for a fixed sum outright), designations as developer, financing commitments, variances, permits and licenses from federal, state, or municipal bodies, and rights in architectural plans. In some cases, where the community group has some capital, it may contribute cash prior to the closing of the construction loan.

14 . The developer, contractor or other entity(ies) acting as additional general partner(s) is entered here. In some cases a community group may act individually as did RAP in Boston, Massachusetts.

15 . The contributions to be made by the Developer vary as much as those made by community groups, and often it is the relative contribution of each that determines the allocation of profits between the General Partners. Where the Developer does almost all the work, as The National Housing Partnership is prepared to do, you can expect changes in the bargaining positions of each party. In its standard agreement, The National Housing Partnership reserves the right to remove the local partner altogether if it does not satisfactorily carry out the joint policy of the partners. Again, contrast the amount the the community group gets in Scenario A with what it gets in Scenario B.

16 . This Agreement is drafted to apply to those cases in which the Partnership knows in advance how much the Limited Partners will contribute, and the Agreement assumes that each Limited Partner will contribute the same amount. It is perhaps more realistic to refer to Schedule A in which an amount is set opposite each investor's name. This is because a broker may sell different portions at different prices, depending on market conditions at the time of sale. In some cases a broker will just pay the Partnership a previously determined set sum and will sell the Units for what he can get. In such cases, the broker just informs the Partnership of what persons own what percentages.

Units to be offered is ____________. In no event shall a Limited Partner be liable for any obligations of the Partnership in excess of the total amount to be paid for his Limited Partnership Units pursuant to this paragraph 5. 2.

(b) The foregoing cash contribution shall be made by each of the said Limited Partners as follows: [17]

(1) ______________ percent (%) [18] shall be due and

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17 . Although each Limited Partner is committed for the full amount of the Partnership Unit upon signing the agreement, he will pay the purchase price in installments. As more fully discussed in the Introduction to Section III, this increases the discounted rate of return to the investor. The number of Units offered will ordinarily be small (determined by Counsel's judgment of the need to meet the requirements of State and Federal Security Laws).

18 . The percentages should be calculated to assure any necessary cash requirements. The number of installments and their timing is in some degree arbitrary, although timing will seriously affect the rate of return on investment. The Limited Partners will bargain to put their money in as late as possible, as this increases rate of return and may reduce the investor's risk. In this agreement, the investor's risk is not substantially reduced by the spacing of payments, because if the Project is going badly at the time an additional payment is due, the investor must still put up the money. However, the investor is likely to bargain to make the later installments dependent on the successful completion of a given phase of the Project. Thus, the investor may insist that the second installment not be payable until the Project has been completed to the satisfaction of the Commissioner of the FHA progress report. This might be 50% of completion or at final close (when the permanent mortgage is awarded). The last installment might not be due until the Project has 90% or 95% of the dwelling units under written lease at a specified total rent with no concessions made to lessees. Such payment clauses would usually include a time limit, so that, for instance, if the construction was completed more than two years after the signing of the agreement, the Limited Partners could refuse to make further payments. Thus, these clauses shift the risk of loss, if the Project is not successfully completed, to whomever would have received such installments. This would be the General Partners in this agreement. It should be noted, however, that a recent promulgation of the Board of Governors of the Federal Reserve System (37 Fed. Reg. 6586, March 31, 1972) interprets Part. 220 of Treasury Regulation T in a way which limits the use of phased payments where the sale of the limited-partnership interests is not exempt from registration with the Securities and Exchange Commission. The Board's position is that agreements that allow a limited partner to pay for his partnership interest over time are agreements to extend illegal credit to the investor. Regulation T apparently does not apply to "exempt" sales of securities such as private placements and intrastate offerings, but community groups may find they have to deal with syndicator-brokers who express concern about selling phased payment deals.

payable upon the Initial Close of the mortgage.

(2) __________ percent (%) shall be due and payable within 6 months of the Initial Close.

(3) __________ percent (%) shall be due and payable within 1 year of the Initial Close.

(c) Schedule A attached hereto shall be amended from time to time to reflect the withdrawal or admission of Partners, any changes in the Partnership Interest of any Partner arising from the transfer of any part of a Partnership Interest to or by such Partner, and any changes in the amounts contributed or agreed to be contributed.

(d) A capital account shall be established for each Partner and shall be credited with the amounts of his capital contributions to the Partnership from time to time. Any Partner, including any substitute Partner, who shall receive a Partnership Interest or whose Partnership Interest shall be increased by means of the transfer to him of all or part of the Partnership Interest of another Partner shall have a capital account which has been appropriately adjusted to reflect such receipt or transfer. [19]

(e) Any Partner who shall acquire any Partnership Interest by means of the transfer to him of all or any part of the Partnership of any other Partner shall, with respect to the Partnership Interest so transferred by him, be deemed to be a Partner of the same class as his transferor.

(f) In order to secure to the Partnership the receipt of the balance of the cash contributions to be made by the Limited Partners after the initial installment is paid, each Limited Partner

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19 . This capital account is kept for several purposes. Article 11. 5 provides for a change in the allocation of profits and losses between the General Partners and the Limited Partners when cash distributions to the Limited Partners equal the amount in this account. Further, this account is one crucial input to determining the tax basis of a partnership interest for a partner selling his interest. Sellers of property are taxed on the difference between their basis in the property and the selling price.

hereby agrees that any Limited Partner who shall default in the payment of any of the installments required to be paid, as aforesaid, shall forfeit his Limited Partnership Units and the monies contributed by him prior to such default and shall be liable to the Partnership for all damages caused by his default.[20] The General Partners, acting on behalf of the Partnership, may sell the forfeited interest to such persons and on such terms and conditions as it deems appropriate, provided that the General Partners shall first have offered such defaulted interest to the remaining Limited Partners on the same terms and conditions.[21] The remaining Limited Partners may purchase such defaulted interest pro rata according to the number of Limited Partnership Units owned by each interested Limited Partner.

(g) No Limited Partner shall be required to make any additional capital contribution to the Partnership.

5.3 Investment Representation.[22] By execution hereof, each Limited Partner warrants and represents that the Partnership interests

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20 . This clause puts a heavy burden on the defaulting investor, since if the Unit cannot be resold, the Partnership can sue him for damages which could conceivably be more than the investor originally contracted to pay. Other language should be used if the investor is only to be liable for his original contract amount. A different clause may be demanded by the investor; one which would entitle him to be paid back his prior investment if the Unit were resold or at the very least would cut off his liability for any defaulted payments.

21 . This provision may be spelled out in much greater detail, giving, for example, time limits for the Limited Partners to respond to an offer. See Article 10.4(a). The General Partners might wish to try to get the right of first refusal for themselves at a cost of the defaulted amount. They might do this if they could resell it for a greater price and realize a profit.

22 . This clause is intended for those cases where the Partnership is to be marketed under the private placement exemption to the registration requirements of the Securities Act of 1933. The investors must be buying without any intent to resell in the foreseeable future and this clause gives some protection to the sellers against future suits by one of the investors or the Securities and Exchange Commission.

acquired hereby are only for his own account, and that he has no present intention of selling, distributing, or otherwise disposing of all or any part of such interest. Each Limited Partner acknowledges that such Limited Partnership interests have not been registered under any state or federal securities statute in reliance on such warranty and representation.

5.4 Capital Withdrawal. There shall be no right to withdrawal of capital by the Partners except as provided herein.

5.5 Interest. No interest shall be paid on capital contributions.

5.6 Additional Capital and Partners. The General Partners are expressly prohibited from accepting additional contributions to capital and from admitting additional Limited Partners to the Partnership.[23]

5.7 Loans from General Partners. The General Partners shall not be obligated to contribute any capital to the Partnership other than what is required by Article 5.1.[24] To the extent that the financial requirements of the Partnership during the construction period (that period prior to closing the permanent mortgage loan), cannot, from time to time, reasonably be satisfied from capital contributions made by the Limited Partners and/or from the proceeds of any financing, the General Partners[25] shall, from time to time, lend the required amounts to the Partnership. Such non-interest-bearing loans shall be

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23. In some partnership agreements provision is made for the possibility of admitting additional Limited Partners if additional capital is required.

24. The partnership agreement may require that the general partners leave some of the money they are to receive from the syndication in escrow as a guarantee fund. This Agreement does provide for this in Article 5.9(b).

25. It may be desirable to specifically designate which general partners will make such loans and in what amounts or proportions. Sometimes the Agreement provides for borrowing from sources other than General Partners. For instance, one could allow borrowing against the expected installments from Limited Partners. If the Limited Partners signed subscription agreements, these may be saleable to a commercial lender. This might result in enough cash to allow the Partnership to spread out the phasing of the Limited Partners even more and thus obtain a larger total capital contribution.

repaid from the net capital contributions of the Limited Partners as described in Article 5.9.[26]

5.8 Purchase Price of the Land. At Initial Closing [27] the Partnership shall purchase the land for $__________ or the appraised value thereof as determined by the FHA, whichever is lower. [28]

5.9 Use of Limited Partners' Capital Contribution. The net capital contributions (after deduction of the costs of syndicating the Units) [29]

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26 . Article 5.7 details one of many kinds of arrangements that can be made to cover the contingency of the necessity for further "capital," that is, the loan is repayable out of the syndication proceeds. Some community groups are forced to go so far as to agree to contribute all the needed money with no provision for payback in any way. At least one group arranged to have the loans treated as a straight interest bearing loan with an interest rate 1 1/2 points above prime rate, repayable as quickly as possible out of operating revenues (net partnership receipts) before even the limited dividend could be paid. It is unusual to see interest paid on such loans as it can build up to enormous amounts very quickly.

27 . Initial closing is when the loan for construction is finally received. The construction loan is a temporary loan, which is paid off at "final closing" when the permanent mortgage is received. "Final closing" takes place when construction is completed.

28 . The Partnership cannot pay more than the FHA appraised value of the land and still recover the full cost from the mortgage proceeds. If the fair market value allows it, a figure set higher than the cost at which the land was obtained can be recovered from the mortgage and is in effect one way of obtaining a portion of the syndication proceeds for the community group. This would also be an early and riskless way to obtain money. Further, any profit would probably be capital gain if tax considerations are of any concern. If a figure lower than the appraised value is set, this may reflect a subsidy to the Project by the community group. The lower land price translates into lower rents. The cost to the community is that it does not receive outright all the cash it could hope for from the project proceeds, and thus it has fewer resources to devote to other community projects. Some community groups have decided to subsidize in this manner, but in general it is not very efficient. For instance, a $100,000 difference in land cost might translate in a 200-unit project into rents that are $1.25 per month lower than might be expected; $100,000 to the community group might be of more long-term value to the community.

29 . The Limited Investors are willing to purchase Units at a price that will yield them their desired discounted rate of return. However, this gross amount is not usually remitted to the Partnership. In most cases, there will be a broker's or syndicator's fee.

of the Limited Partners shall be used by the Partnership as follows:

(a) First to meet any cash requirements of FHA with regard to the financing of the construction of the Project; [30]

(b) Second, to pay the general contractors profit which shall be ________ [31] percent of the cost of land improvements and construction;

(c) Third, to establish a guaranty fund [32] of up to 16 2/3 percent,

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30. Some cash must be put up by the Partnership for development of the Project. Three costs must be covered. First, the federal mortgage only covers 90% of the estimated replacement cost. Part of the 10% gap is met by the Builder's and Sponsor's Profit and Risk Allowance (see Section I, under "Financing Programs," for more detail), but there is still a portion to be met by Partnership assets. Second is any off-site costs (e.g., sewer connections) not covered by the mortgage. Third is the cost of meeting FHA's requirement of 2% of the mortgage for working capital. It should be emphasized that the order of use of the syndication proceeds established in Article 5.9 will not be the ideal solution in other situations. Priorities must be set to meet particular conditions. General partners who cannot meet the 15% net worth requirement of the IRS (see Introduction to Section III, under "Substance Versus Form") may wish to try to get some of the earliest syndication proceeds out of the partnership at the beginning in an attempt to satisfy the IRS.

31. In Limited Dividend financing there is no provision for a general contractor's profit under the mortgage. This separate provision is usually made from the syndication proceeds. The percentage varies with the size of the deal and may run from 3 to 10%. If the contractor is large, it may be capable of doing a lot of its own subcontracting work and thus make the usual subcontractor's profit. The community group should be aware of this potential profit to the contractor in negotiating any other payment. Professional developers often get a builder to forget any payment from the syndication proceeds. The subcontractor's profits should be kept in mind especially where the general contractor is related to one of the general partners. The general contractor's profit may have a lower priority in other agreements. It might come after Article 5.9 (e), for instance.

32. A guaranty fund or escrow account is a common feature of partnerships where the local general partner receives a large proportion of the proceeds. Generally, the local group can receive a larger share if it is willing to put part of it at risk. The usual guaranty fund guarantees payments of the Annual Distribution and/or a general operating deficit. In at least one case, the guaranty fund was to secure the builder against strike risks -- unusual, to say the least. This guaranty fund usually would exist for a limited time -- say five to ten years. In fact, the language of Article 5.9(c) in an actual agreement should spell out the escrow timing in detail as well as who will get what portion of the remaining fund. See Article 5.7(f).

or such other amount as the General Partner deem necessary, of net capital contributions of the Limited Partners;

(d) Fourth, to pay the costs of organizing the Partnership,[33] including the costs of attorneys, accountants, special attorneys and consultants, if any, whether such costs were paid by the Partnership or by any of the General Partners, where such costs were not reimbursed under the mortgage;

(e) Fifth, to repay the loans, if any, made pursuant to Article 5.7;

(f) Sixth, to share among the General Partners for work performed for the Partnership in the following proportions:[34]

60 percent Developer

40 percent Local General Partner

The amount to be shared by the General Partners in (f) shall include any of the amount set aside in (c) that is still in the fund when the fund expires by its terms.[35]

6. RIGHTS, DUTIES, AND POWERS

6.1 Rights of the General Partners. The General Partners shall, except as otherwise expressly provided, have the exclusive

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33. There are several costs involved in organizing a Limited Partnership. Some the General Partners may bear in their individual capacity, some may be borne by the Partnership. This clause is intended to reimburse those who bore these expenses. The amount of the expenses will vary. In some cases the broker's fee will include a number of these items. It should be remembered that this clause is not intended to reimburse anyone for expenses to be recovered under the mortgage nor is it intended to reimburse for expenses like those recoverable under the mortgage but where a larger amount has been expended.

34. This proportion is one of the major bargaining points between the Developer and the Local General Partner.

35. Article 5.9 assumes that as phased payments come in pursuant to Article 5.2 that they will be used totally to pay 5.9(a) amounts and then 5.9(b), etc., in order.

right to manage the Partnership business.

6.2 Duties of the General Partners.

(a) The General Partners shall use their best efforts to develop the premises as provided herein and otherwise to comply with this Agreement. The General Partners shall use their best efforts to obtain construction and permanent first mortgage loans from the FHA pursuant to the FHA commitments therefor and to comply with such requirements as are imposed on the Partnership and the premises by the FHA or in connection with FHA borrowing. If the General Partners obtain financing as aforesaid, they shall, simultaneously with or prior to the construction loan closing, purchase, on behalf of the Partnership, the premises at the price determined in Article 5.8 and cause construction to be completed and rental housing to be provided to families and individuals of low- and moderate-income, in conformity with the terms hereof and the requirements of the FHA and other applicable regulatory bodies.

(b) After substantial completion of the construction work on the premises, the General Partners shall operate and arrange for the leasing, operation, management, maintenance, and repair of the premises thereafter in accordance with the terms of this Agreement and with applicable laws, regulations, and agreements with the FHA and other governmental bodies having jurisdiction. Each General Partner shall devote such time to the affairs of the Project and the Partnership as they reasonably deem necessary to perform their duties.[36] The General Partners shall not be entitled to reimbursement for expenses or compensation for duties performed as General Partners for the Partnership in carrying out their obligations under this Agreement, except as provided in Article 5.9(f), including without limitation, accounting, record

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36. It is desirable to be more specific. For instance, the Developer and/or Local Partner may assign a number of people half- or full-time to the Project.

keeping and the like, [37] except the General Partners may be reimbursed for expenses of the Partnership that they have paid as an accommodation to the Partnership.

(c) The General Partners shall not, on behalf of the Partnership, engage in any business activities or invest any Partnership funds, except in connection with the development and operation of the premises for the purposes set forth herein, provided, however, that they may invest cash of the Partnership in United States Treasury bills, certificates of deposit, and insured savings accounts in commercial banks, savings banks, and loan associations. [38]

(d) [Additional Clause for Rehabilitation Projects].[39] The General Partners shall lease and otherwise operate the premises to qualify such premises as low-income rental housing in order to be eligible for depreciation as provided in Section 167(k) of the Internal Revenue Code of 1954 as amended or any equivalent statute superceding that Section. The Regulations promulgated pursuant to

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37 . FHA mortgage proceeds do not allow for a fee to be paid to the General Partners for such things as partnership record keeping. Of course, if a General Partner is acting as manager of the Project, a management fee is payable. Another possible source of funds for a General Partner is part of the legal and organizational fee allowed under the mortgage. Or, in some cases, the split of the syndication proceeds is handled in such a way as to provide a fee for one or another partner to manage the Partnership. This can be paid early in the life of the project or can be subject to contingencies as are the proceeds of Article 5. 9(f).

38 . This is a fairly conservative clause. You might also allow Partnership assets to be placed in commercial paper. Sometimes you may want to have even more venturesome investments, especially with money in any escrow account. On the other hand, lenders may be very conservative and specify their own short list of possible investments.

39 . This clause is intended to qualify rehabilitation projects for the five-year accelerated depreciation provided by Section 167(k) of the Internal Revenue Code. It is not needed for new construction projects.

whatever Section of the Internal Revenue Code then in effect shall be satisfied at all times.

6.3 Powers of the General Partners.[40] The General Partners shall have the power on behalf of the Partnership to do any and all acts as they reasonably deem necessary or appropriate for the performance of their duties. Without limiting the generality of the foregoing, the General Partners' powers shall include the following, unless otherwise expressly prohibited or limited by the terms hereof:

(a) to execute all documents that are requested by the FHA to be executed including, without limitation, a note, mortgage, loan agreement, and regulatory agreement;

(b) to apply for and obtain any and all variances, permits, and the like as are appropriate for the proposed development of the premises;

(c) to contract or assume existing contracts with architects, general contractors, and other appropriate participants in the development work to be done on the Project;

(d) to hold, manage, enter into management agreements for the Project and to lease rental units therein or the Project in its entirety on a long- or short-term basis (so long as FHA approves and the tax benefits to the Partnership are not changed),[41] to borrow money to the extent of operating requirements (including, without limitation, amounts necessary or appropriate for the management, operation, maintenance, repair and/or replacement of improvements and the creation of reasonable reserves therefor), all of the foregoing at such price, rental, or amount, and upon such terms as they reasonably deem proper (and as FHA approves).

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40 . Article 6.3 describes the powers of the General Partners jointly in relation to the Limited Partners. The split of powers between the General Partners is in Article 7.

41 . FHA may have a problem with very short-term leases. They do not approve of rentals to transients. On the other hand, there may be a problem with the Internal Revenue Service if the entire Project is let in one lease on a very long-term basis. The IRS may argue that the Partnership no longer really owns the Project and thus deny the Partnership depreciation tax deductions.

The General Partners shall not, however, lease the Project or parts thereof for a term or terms which run beyond ________;[42]

(e) at any time on or after ______________________, [43] to sell, exchange, or convey title to the Project or any part thereof, all of the foregoing upon such terms as the General Partners reasonably deem proper and at such price as they reasonably believe to be the fair market value after obtaining a professional appraisal, [44] provided that the foregoing may be done by the General Partners prior to ___________________, [45] upon the prior written consent of Limited Partners representing 75 percent of the aggregate amount of capital contributed by the Limited Partners; [46]

(f) subject always to any requirements of the FHA, to mortgage all or any part of the Project, to obtain replacements of

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42 . This clause is not always necessary. The usual apartment lease is for one year at a time. If there are to be commercial leases, this clause is aimed at leaving the building without any uneconomic leases at the time the owners are likely to want to sell it. Thus, the date to be inserted might be 10 years from Final Endorsement for new construction and 16 to 17 years for rehabs, since at that time there is no longer any recapture of depreciation under present tax laws.

43 . This date will probably be the same as that described in footnote 42.

44 . Some partnership agreements make explicit provision for sale at $1 above the remaining mortgage (or some other "below market value" price) to the tenants or other local community group. This kind of sales provision is frowned upon by many tax lawyers as jeopardizing the depreciation deductions for the Limited Partners. See Introduction to Section III, under "Substance Versus Form."

45 . Same as footnote 43.

46 . Requiring the consent of all the Limited Partners is risky. With more than a few Limited Partners there is sure to be one holdout. However, the 75% requirement is arbitrary and can be anything above 51%. Another or an additional provision might be to allow for sale prior to the set date without Limited Partner consent if the sale were in accordance with the "rollover" provisions. Such a sale would defer any application of depreciation recapture.

any mortgage or mortgages on the Project, and to prepay, in whole or in part, refinance, recast, increase, modify, consolidate, correlate, or extend any mortgages so long as no taxable event under Federal Tax Law results; [47]

(g) to place record title to the Project in their own names or in the name or names of a nominee or nominees for the purpose of holding the same mortgage financing or any other convenience or benefit of the Partnership;

(h) to employ from time to time persons, firms, or corporations for the development, operation, management, and leasing of the Project, including without limitation, supervisory managing agents, building management agents, brokers, accountants, and attorneys, on such terms and for such compensation as they shall reasonably deem proper, except that this clause does not apply to any positions covered by Article 8 of this Agreement;

(i) to collect and receive all monies, refunds, repayments, and the like due to the Partnership whether from Partners or third parties, and to institute legal action therefor if appropriate and to disburse monies to the Partners in accordance with the terms hereof;

(j) to discharge all obligations of the Partnership, to defend suits, and the like;

(k) to execute, acknowledge, and deliver any and all instruments to effectuate the foregoing.

By way of extension and not in limitation of the foregoing, the General Partners, to the extent consistent with the provisions of this Agreement, shall possess all of the powers of a partner in a partnership without limited partners under the Partnership Law of ____________.[48]

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47 . In some agreements refinancing also requires Limited Partner approval. Generally, the Limited Partners just want protection against an event occurring that will alter the tax benefits they expect to get from investing in the Partnership. Thus, one of their concerns is foreclosure on the mortgage.

48 . State in which Partnership is formed.

Nothing contained in this Article 6.3 shall be construed as giving the General Partners the power or right to possess Partnership property for other than a Partnership purpose or to do any act prohibited by the terms of any statutes, ordinances, regulations, or agreements or regulatory agreements applicable to this Partnership and/or to the Project as developed hereunder.

6.4 Independent Ventures -- Self-Dealing Provisions.

(a) Any Partner, General or Limited, may engage in or possess an interest in other business ventures of any and every nature and description, independently or with others, including, but not limited to, ventures in the building and construction business and in purchase, ownership, development, financing, leasing, operation, management, syndication, brokerage, and development of real property.[49] Neither the Partnership nor the other Partners shall have any right by virtue of this Agreement in and to such independent ventures or to the income, gain, or profits derived therefrom.

6.5 Contracts with Affiliated Persons. In the exercise of their authority pursuant to the preceding sections, the General Partners may employ or acquire property or services from persons who are Partners or related to or affiliated with Partners.[50] Any such transaction shall be fully disclosed to all Partners and shall be on terms at least as favorable to the Partnership as would be obtainable from unaffiliated

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49 . Community groups may wish to bargain for the right of first refusal with a Developer for any other housing project the Developer contemplates constructing in the neighborhood. The developer may also ask for a reciprocal right of first refusal.

50 . This section allows the Partnership to contract with related persons. Although in the usual situation this section would exist to allow the Partnership to make the Developer the Contractor for the Project, it could also be used to let a contract to an affiliate of the community group. For instance, a community development corporation might have a subsidiary making prefabricated walls or plywood sheets, or a maintenance or management unit.

persons.[51] The General Partners' reasonable determination as to the amount of any compensation paid or any rental income received shall be conclusive and binding on the Partnership and the Partners.

6.6 Indemnity of the General Partners. Except to the extent that a General Partner incurs loss or damage caused by his bad faith acts or gross negligence, the Partnership shall indemnify and save harmless the General Partners from any personal loss or damage incurred by them by reason of any act performed by them for and on behalf of the Partnership and in furtherance of its interests or arising out of any business of the Partnership.

6.7 Activities of the Limited Partners. Except as otherwise expressly provided herein, the Limited Partners shall take no part in, nor interfere in any manner with, the conduct or control of the Partnership business, and shall have no right or authority to act for or bind the Partnership.

6.8 Power of Attorney. Each Limited Partner hereby irrevocably constitutes and appoints the General Partners, including any Substituted General Partner, its true and lawful attorney, in its name, place, and stead to execute any instruments necessary to the conduct of the Partnership business.

6.9 Insurance. The General Partners shall obtain and keep in force comprehensive general liability, fire and extended coverage, rental income, and other insurance required by FHA, or the lenders,[52] in such amounts and on such terms as will adequately protect the Partnership.

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51 . Sometimes an affiliated person will be manager and will bargain for a larger fee in return for subordinating the right to that fee to operating losses. This arrangement should be allowable.

52 . Such other insurance might include protection against boiler-explosion, collapse, crime, vandalism, riot, civil disturbance, or workmen's compensation.

7. RELATIONSHIP BETWEEN LOCAL GENERAL PARTNER AND THE DEVELOPER [53]

7.1 Decisions Requiring Approval by Both General Partners. The overall management and control of the Partnership business shall be vested in the General Partners collectively. Policy decisions regarding the operation of the Partnership business, such as would normally be within the jurisdiction of a corporate Board of Directors, shall be made jointly by both General Partners. [54] Without limiting the generality of the foregoing, such decisions shall include: [55]

(a) approval of each member of the Development Team named in Article 8 of this Agreement, and the form and substance of contracts with such persons,

(b) admission of Substituted Limited Partners as provided in Article 10.2 of this Agreement,

(c) approval of preliminary and final architectural and engineering plans, specifications, and working drawings, [56]

(d) architectural or construction change orders,

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53 . This relationship is one of the major bargaining areas. As stated in the Introduction to Section III, these provisions might be part of an entirely separate Joint Venture Agreement. The actual functions to be performed by each General Partner will reflect the interests and capability of the Local General Partner. For further discussion of possible relationships, see Sections I and II of this paper.

54 . This Agreement makes most decisions a joint enterprise. Although this Agreement does not spell out what should happen if the two General Partners disagree, a dispute settlement procedure probably should be carefully worked out and included in this Article. The procedure should be one that is as informal, quick, and cheap as the parties can devise. It should thus use local people familiar with the housing field and sensitive to community needs.

55 . The following list gives a good sampling of the kinds of decisions the Partnership will be called upon to make, although it makes no attempt at being all inclusive.

56 . This decision can affect all others. In some agreements a general description of the parties' expectations is included. Thus, the approximate number of studio, one-bedroom, two-bedroom, three-bedroom, and four-bedroom apartments is delineated. This might be supplemented by projected rent levels.

(e) timetable and budget for release of construction funds,

(f) the amount and terms of the performance and payments bonds, or Completion Assurance Agreement executed by the General Contractor,

(g) approval of the annual budget of estimated receipts and expenditures of the Partnership, [57]

(h) determination of the amount and timing of cash distributions to the Partners,

(i) approval of the rental and management policies for the Project, [58]

(j) determination of the types and amount of insurance carried by the Partnership, and the identity of the insurance carriers,

(k) borrowing on the credit of the Partnership, and

(l) refinancing of the mortgage loan.

7.2 Functions of Local General Partners. The Local General Partner shall have responsibility for, and control over, the ordinary and usual day-to-day management and operations of the Partnership business and the implementation of policy decisions made jointly by both General Partners. [58a] The Local General Partner shall disperse

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57. These kinds of decisions are intimately related to how the building will be maintained, who the tenants will be, and other topics of great concern to the community. Some groups may wish to have the final say here. It must be remembered, however, that the more powers given to the local group the more difficult it will be to syndicate the product. Thus, the local group may have to balance cash in hand with other social housing objectives.

58. It is more usual to find the Developer as Managing Partner. On the other hand, some local Partners may want more of a policy say. See footnote 57 above.

58a. See footnote 57 above.

Partnership funds in accordance with the budget approved by both General Partners.

7.3 Decisions Which May Be Made by the Developer Alone. [59]

8. DEVELOPMENT TEAM [60]

8.1 Special Agents. The special agent authorized to act on behalf of the Local General Partner within the scope of Articles 6 and 7 of this partnership agreement is ________________________, [61] unless such agency is terminated and notice given pursuant to Article 15.3.

The Developer authorizes the following chief executive officers, [62]

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59 . This has been left blank purposely. Whatever is not done jointly or by the Local General Partner will be done by the Developer. The Developer may have contingency powers. Thus he may become Managing Partner if revenues fall below a certain level or the Annual Distribution is not paid. On the other hand, in at least one agreement where the Developer starts out as Managing Partner, provision is made to transfer management to the Local General Partner if the Local Partner feels the budget (rents) are too high. If any losses occur while the Local General Partner is managing, they come out of the Local General Partner's share of the guaranty fund. Beyond a certain limit on losses the control is transferred back to the Developer.

60 . There are several ways of deciding upon a development team. This Article is suitable for a situation where the Partners have already decided on each party. Another method would be to attach standard form architectural and contractor contracts along with an indication of who will decide on the party to the contract.

61 . This is a formal way of designating the negotiator for the Local General Partner so that the Developer knows who has the decision-making authority.

62 . It is especially important to the community to know who has the negotiating authority for the Developer.

namely: ________________________ and ________________________ to act as special agents on his behalf within the scope of Articles 6 and 7 of this partnership agreement unless such agency is terminated and notice given pursuant to Article 15. 3.

8. 2 Syndicator. The broker or syndicator designated to offer, by a private offer, [63] the Limited Partnership Units shall be ________________________, except that the contract with ________________ and the proposed terms of such offer shall require the unanimous consent and approval of the General Partners.

8. 3 Accountant for Partnership. The certified public accountant for the Partnership is hereby designated to be ____________________. A unanimous vote of the General Partners is required to substitute a new accountant for the Partnership. [64]

8. 4 Partnership Attorney. The attorney for the Partnership who shall act as attorney-of-record at the mortgage closing for construction financing and at the mortgage closing for permanent financing shall be ________________________. The fee allowed for such legal services shall not be more than 40 percent of the total legal and organizational fee allowed by either HUD or FHA. The balance of the legal and organizational fee shall be paid 50 percent to the Local General Partner and 50 percent to the Developer. [65]

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63 . This makes the type of marketing explicit. However, the entire clause should be eliminated unless there is a firm deal with a broker. This is a clause for a joint venture agreement in any case.

64 . The Limited Partners may demand some say in who the accountant shall be.

65 . It is not necessary to set a limit on legal fees. This Agreement does so because the parties contemplate that much of the legal and organizational work necessary to the financing (and compensated for under the FHA formulas) will be done in house. In particular the Local General Partner may have the benefit of free consulting and legal services. Thus, the General Partners wish to be compensated for their work right from the mortgage proceeds. Of course, the 50-50 split described here is a negotiable item between the partners. This stated fee is only for financing. The lawyer who arranges the partnership syndication will usually demand a substantial fee which will be paid

8.5 Special Attorneys. The Partnership shall employ from time to time and at reasonable costs such other attorneys who shall represent the best interests of the General and Limited Partners, upon the unanimous consent and approval of the General Partners.

8.6 General Contractor. The Partnership hereby designates ______________________________ [66] as the proposed general contractor for the Project. ______________________________ shall build pursuant to a form of Construction Contract known as a "cost plus fixed fee, with guaranteed upset price," substantially the same as FHA Form 2442A. [67] Substitution of a new general contractor

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out of the proceeds. A sample of other legal work that might arise includes obtaining zoning variances, dealing with urban renewal agencies, and real estate taxes. If this work must be paid for, the amount allowed by FHA for legal and organizational costs may quickly disappear.

66. Community groups should be aware that one of their bargaining options is to push for a community owned and controlled contractor. However, this is a particularly tricky thing to bargain for. To start, investors are put off by the idea. Second, limited-dividend deals only result in potential profits for the community if the project is a large one, say 200 units, and the bonding requirements for such large projects are usually too high for community contractors to meet. On a smaller contract SBA can help arrange bonding, but a 30- or 40-unit project is better suited to nonprofit sponsorship help. However, it might be possible to arrange for community subcontractors if the Developer is to act as contractor. Another option is to write in requirements for employment of qualified local residents and for on-the-job training with an outside contractor.

67. "Cost plus fixed fee, with guaranteed upset price" is the usual form of construction contract and protects the Partnership while guaranteeing a fair profit to the contractor. The guaranteed upset price means that this is the maximum amount the Partnership will pay. In theory, this type of contract encourages the contractor to build for the least cost possible, since his fee is fixed and the guaranteed upset price means that he cannot allow costs to go up indefinitely without cutting into his own fee. In the past there was little incentive to bring the project in for less than the guarantee, and since it is less difficult to build under a larger budget (planning need not be as efficient), the guaranteed price was usually reached. At present FHA allows any construction savings to be shared with the contractor so the situation may be changing. Further, it might be useful to offer an unaffiliated contractor incentives to finish early. To be trite: time is money. If the Project appears to be coming in at less than the agreed upon cost, savings might be used to upgrade the Project rather than reduce the mortgage.

shall require unanimous vote of the General Partners. A unanimous vote of the General Partners shall be required for approval of each and every subcontract entered into by the general contractor, or any substitute general contractor since it is an explicit goal of the Partnership to have local employment to the maximum extent feasible.[68]

8.7 Architects. The design architect for the Partnership is hereby designated to be ______________________. Unanimous vote of the General Partners shall be required to substitute a new design architect. The design architect shall work with __________,[69] or such other supervisory architect approved by a unanimous vote of the General Partners. The supervisory architect's responsibility and duties shall lie solely in the area of supervision of construction. The design architect shall not approve and/or certify the completion of any construction work without prior approval and/or certification by the supervisory architect, and the architect's contract with the Partnership shall so specify. The total fee, which is no event shall be in excess of those specified on FHA Form 2264 accompanying the satisfactory FHA Commitment, and the amount advanced from time to time to either the design architect or the supervisory architect shall require unanimous vote and/or consent of the General Partners. No plans or specifications shall be submitted to FHA without the prior written approval of all General Partners.

8.8 The Management Agent. ______________________[70] is

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68 . It may be unrealistic to demand control over every subcontract. However, it may be possible to obtain the statement of goal contained in the latter part of the sentence.

69 . This Agreement contemplates two architects. One architect may be able to fulfill both functions.

70 . The choice of a management agent is one of the most important points of negotiation. The community group might feel that it is a key requirement for them to manage the building. If this is true, the community must be prepared for making some tradeoffs. It will be more difficult to sell Limited Partnership Units without a professional manager and the Developer will expect a larger percentage of the smaller pie. For this and other reasons (e.g., some community groups don't want to be seen as day-to-day landlords) many groups are prepared to let a professional manage.

hereby designated as the management agent for the Project and may be substituted only upon unanimous vote of the General Partners. ______ __________________ shall be paid for its services, as management agent for the property, no more than the maximum fee allowed by FHA. ______________________ shall employ on a full-time basis at least _______________ persons residing in ______________________ and these persons shall be paid reasonable compensation by the management agent while they are trained in all phases of property management.[71] The employment contract between ___________________ and the trainees, must be approved by a majority of the General Partners prior to execution of any property management contract between the Partnership and __________________________. The management contract shall provide that a new management entity may be substituted subject to FHA approval, upon a unanimous vote of General Partners. Prior to the execution of the management contract ___________________ shall provide to the General Partners a management plan[72] including, among other things, detailed particulars of its lease, grievance procedures, policy on tenant selection, tenant eviction, tenant relocation, property maintenance, rent collection procedures, and on-site property management personnel and supervisors.[73] The proposed management policy may be modified and approved by the General Partners and incorporated where appropriate and subject to HUD or FHA approval, into the management contract.

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71 . If a professional is managing, the community group still has other options. They can, as here, require that certain residents be trained in management. Sometimes the community group pays part of the salary of the trainees. Sometimes the trainees will be hired for work in other projects managed by the same agent. Another possibility is to have residents used in providing security services for the Project.

72 . A management plan is now required by FHA in the early stages of processing a mortgage application.

73 . The General Partners (or either General Partner alone) may keep the power to set all major policy decisions that will merely be carried out by the manager.

9. REMOVAL OR SUBSTITUTION OF A GENERAL PARTNER

9.1 Grounds for Removal of General Partner.[74] A General Partner shall be removed if it has violated in a material respect a provision of this Agreement or any law or regulation applicable to the Project, or in the conduct of its own affairs or those of the Partnership has jeopardized the eligibility of the Partnership to be treated as a partnership for purposes of Federal income taxation, in accordance with the then existing regulations and policies of the Internal Revenue Service.

9.2 Incapacity of General Partner. The death, legal incapacity, withdrawal, dissolution, bankruptcy, or assignment for the benefit of creditors of a General Partner shall not cause the dissolution of the Partnership. Upon the death, legal incapacity, resignation, bankruptcy or assignment for the benefit of creditors of one of the General Partners (if there be more than one), the interest of such General Partner shall descend to and vest in his heirs, legatees, successors, legal representatives, trustee, receiver, or assignee for the benefit of creditors, who shall be admitted as Substituted Limited Partners in accordance with Article 10.2 of this Agreement. Upon the death, legal incapacity, resignation, bankruptcy, or assignment for the benefit of creditors of the sole General Partner, a Substituted General Partner may be selected by the concurrence of Partners holding in the aggregate more than 75 percent[75] of the total Percentage Interests. If such concurrence is not obtained within fifty days after notice is sent to the Limited Partners of the event requiring a Substituted General Partner, the Partnership shall forthwith be dissolved.

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74 . It is important to make the grounds for removal limited and definite. Otherwise the Local General Partner might find itself pushed out of the picture.

75 . This percentage is to some extent arbitrary.

9.3 Procedure for Removal of General Partners. If either General Partner ("the Objecting Partner") [76] believes that there is a ground for the removal of the other General Partner, as specified in Article 9.1 or that an event listed in Article 9.2 has occurred, it shall so notify all of the other Partners in writing. The said Partner shall, within ten days after receipt of such notice, send to all Partners an admission or denial of the charge. Failure to respond shall be deemed an admission. If the said General Partner denies such charge, the Objecting Partner shall initiate arbitration in accordance with Article 15.8 of this Agreement. Upon the said General Partner's admission that a ground for its removal exists or that a disqualifying event has occurred, or upon an arbitration award to that effect, it shall forthwith cease to have any rights or powers as a General Partner and shall become a Limited Partner with the same Percentage Interest and with only these rights of a Limited Partnership Interest including the right to the flip-flop of Article 11, except that such part of its Percentage Interest as it sells to a Substituted General Partner shall remain a General Partner Interest in the Partnership.

9.4 Selection of Substituted General Partner. A Substituted General Partner for the Developer may be selected by the concurrence of Partners holding in the aggregate more than 75 percent of the total Percentage Interests so long as any Interest granted the Substituted Partner does not affect the Percentage Interests of the Limited Partners. Otherwise the concurrence of all the Limited Partners shall be required.[77] A Substituted General Partner for the Local General Partner shall be

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76 . It might be possible to allow a Limited Partner to become an Objecting Partner. The problem with this is that the Limited Partners must remain as passive as possible in order to avoid a charge that they participate in management, which would lead to the loss of their exemption from partnership liabilities.

77 . Again, to make the Limited Partners more passive, it may be better to give them only veto power over a name submitted by the Local General Partner.

selected by the concurrence of the Developer and _______________.[78] If a Substituted General Partner is not selected as aforementioned within thirty days after the removal of the sole General Partner, the Partnership shall forthwith be dissolved.

9.5 Partnership Interest of Substituted General Partner. If the Substituted General Partner has been a Limited Partner, a part of its Partnership Interest equal to the General Partnership Interest of the predecessor General Partner shall become a General Partnership Interest including all rights. If the Substituted General Partner is a person other than a Limited Partner, it shall obtain a Percentage Interest with the rights of a General Partner either by purchase of all or part of the Percentage Interest of the predecessor General Partner[79] or by making a predetermined contribution to the capital of the Partnership for a Percentage Interest that is agreeable to all the Partners. In the latter case, the Percentage Interests of all the Other Partners shall be adjusted accordingly.

9.6 Role of Substituted General Partner. The Substituted General Partner shall accede to the duties, rights, and powers of the General Partner it replaces.

9.7 Liability. The outgoing General Partner shall be liable for debts and obligations up to the time of its removal or withdrawal and shall not be liable for anything thereafter.

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78 . The group that is to choose the Substitute for the Local General Partner should go here. This is a very complicated problem as it is important to get someone responsive to the community into this slot. Each community group must think of an organization or group of organizations that could choose a successor.

79 . The outgoing General Partner ought to be willing to sell because his interest is worth more than it would be after a conversion to a Limited Partnership interest. This is because the General Partner's interest includes residual rights in the project out of proportion to the original percentage. (See Article 11.) In fact, because of this, and because it is easiest to get in a Substituted General Partner by means of purchase (with no necessary reallocation of Percentage Interests) and because it may be unfair to a bankrupt or deceased General Partner to lose the extra value, it could be required in the agreement that a Substituted General Partner purchase the predecessor's interest at an appraised or arbitrated sales price.

10. VOLUNTARY TRANSFER OF PARTNERSHIP INTERESTS

10.1 Transfer of Partnership Interest by a General Partner. The Partnership Interest of a General Partner may not be transferred except pursuant to an assignment of its entire interest with the prior written approval or subsequent written ratification of all Partners and the FHA. Any transfer made without such prior written approval shall cause the dissolution of the Partnership unless, within thirty days after such transfer, all Partners shall ratify the same in writing.[80] If the General Partner is also a Limited Partner, it may transfer all or any portion of its Limited Partnership Interest as provided in Article 10.4 of this Agreement.

10.2 Assignment of Partnership Interest by a General Partner. All or part of the Partnership Interest of a General Partner may be assigned without approval so long as the Partnership is notified of such assignee's name and address and the assignment merely means the Partnership must send all checks and notices to the new name and address.[81]

10.3 Substituted General Partner. In the event that all Partners and the FHA approve or ratify transfer of the entire Partnership Interest of a General Partner pursuant to Article 10.1, the transferee shall be admitted as a Substituted General Partner if such transferee has (a) accepted and assumed, in form satisfactory to the Partners, all the terms and provisions of this Agreement and the Regulatory Agreement, (b) provided a certified copy of a resolution of its Board

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80 . It may be better to provide that if the transfer is without approval, the General Partners' interest becomes a Limited-Partnership Interest. This would prevent the Partners being in the position of either accepting an unwanted General Partner or ending the Partnership.

81 . Perhaps assignment should not be allowed if there is a fear that this will lead the General Partner to work less arduously in behalf of the Partnership.

of Directors, if the transferee be a corporation, authorizing it to become a Substituted General Partner under the terms and provisions of this Agreement, (c) provided an opinion of counsel, in form and substance satisfactory to counsel for the Partnership, that neither the offering nor the transfer of the Partnership Interest violates any federal or state securities law, (d) executed a statement that it is acquiring the said Partnership Interest for investment and not for resale, (e) executed such other documents or instruments as may be required in order to effect its admission as a Substituted General Partner, and (f) paid such reasonable expenses as may be incurred in connection with its admission as a Substituted General Partner.

10.4 Transfer of Partnership Interest by Limited Partner. The Partnership Interest of a Limited Partner may not be transferred in whole or in part except with the prior written consent of the General Partners. In no event shall the consent of the General Partners be given unless such transferee has: (a) been approved by the FHA, where such approval is required, (b) accepted and assumed, in form satisfactory to the General Partners, all the terms and provisions of this Agreement and the Regulatory Agreement, (c) executed a power of attorney substantially identical to that contained in Article 6.8 of this Agreement, (d) provided a certified copy of a resolution of its Board of Directors, if the transferee be a corporation, authorizing it to become a Limited Partner under the terms and provisions of this Agreement, (e) provided an opinion of counsel, in form and substance satisfactory to counsel for the Partnership, that neither the offering nor the transfer of the Partnership Interest either violates any federal or state securities law or would cause the termination of the Partnership for federal income tax purposes, (f) executed a statement that it is acquiring the said Partnership Interest for investment and not for resale, (g) executed such other documents or instruments as the General Partners may require in order to effect the admission of such transferee as a Limited Partner, and (h) paid such reasonable expenses

as may be incurred in connection with its admission as a Limited Partner. [82]

10.5 Alternate Transfer Clause. Subject to the following restrictions, any Limited Partner may assign his interest, but he shall not have the right to substitute an assignee as a Limited Partner in his place without the consent of the General Partners. [83] In no event shall a Limited Partnership Unit, or any portion thereof, be assigned or transferred to a minor or incompetent. Any such attempted assignment or transfer shall be void and ineffectual and shall not bind the Partnership.

Restriction I. No Limited Partner shall sell part or all of his interest in the Partnership to a party other than his spouse, parent, heir-at-law, or any charitable or educational organization or a trust for the benefit of any of the foregoing until he shall have made a written offer of such interest to the General Partners [84] at the same price and on the same terms as to the third party (whose name and address must be stated in the offer). If such offer is not accepted within thirty (30) days, the offering Limited Partner may sell to the designated third party or other partner, at the price and terms stated,

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82. This type of transfer of interest section allows transfers to anyone meeting certain stated conditions upon obtaining consent of the Partners. This is to be contrasted with the alternate section below which gives the right of first refusal to the General Partners. It could also be drafted, as is the alternate section following, to allow assignments where the assignee does not act as a Limited Partner.

83. This phrase states that, although a Limited Partner may assign his interest, the assignee cannot exercise the usual right to vote that interest without the General Partners' consent. Further below it is seen that, if the assignment involves a sale, only certain buyers (e.g., spouse or parent) may purchase without an offer to the General Partners.

84. This transfer clause omits a lot of details. It might also provide for the contingency that both General Partners may wish to purchase and provide for an allocation in such a case. It might provide for the General Partners to purchase part of the offer or leave it, as here, on an implied all or nothing basis. It might also provide for a required offer to the Limited Partners, taking into account the above considerations.

within thirty (30) days after the expiration of the thirty (30) day period. If the sale does not occur within that thirty (30) day period, the interest must again be offered to the General Partners pursuant to this paragraph before any contemplated sale.[85]

Restriction II. No Limited Partnership Unit shall be transferred without an opinion of counsel, satisfactory to the Partnership, and its counsel, both that registration is not required under the Securities Act of 1933 and that the transfer will not cause the termination of the Partnership for federal tax purposes.

11. ALLOCATIONS AND DISTRIBUTIONS

11. 1 Profits and Losses

(a) The profits and losses of the Partnership (other than profits or losses of the Partnership arising from the sale or other disposition of all or substantially all the assets of the Partnership) for each fiscal year and for the portion of the fiscal year in which the Conversion Date (defined in Article 11. 5) occurs, shall be determined as of the end of such fiscal year or portion thereof and allocated as follows:

(1) For each fiscal year or portion thereof through the Conversion Date, defined below, 90 percent of such profits or losses shall be allocated to the Limited Partners, and 10 percent of such profits or losses

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85 . The reason for insisting on some restrictions on the right to sell is to prevent the Partnership Units from being freely transferable. This is to make the business arrangement more like a Partnership than a Corporation. See the Introduction to Section III, under "Substance Versus Form."

shall be allocated to the class comprised of the General Partners.[86]

(2) For each fiscal year or portion thereof after the Conversion Date, 50 percent of such profits or losses shall be allocated to the Limited Partners, and 50 percent of such profits and losses shall be allocated to the class comprised of the General Partners.[87]

(b) For federal income tax purposes, all profits[88] and losses arising from the sale or other disposition of all or substantially all the assets of the Partnership or from the items listed in

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86 . In a "perfect world" the percentage of profits and losses assigned to the Limited Partners would equal almost 100% (unless either General Partner could really use the tax deductions) because the more of the tax loss sold to the high tax bracket investors, the larger the syndication returns. However, many tax lawyers have felt that 90% was as much as was safe to assign without jeopardizing the whole partnership status in the eyes of the Internal Revenue Code. Still, some community groups have gone as far as 95% or even 99%. See Introduction to Section III, under "Substance Versus Form."

87 . As stated in the Introduction to Section III, the idea of flip-flop in percentage of ownership is to keep the right to the operating losses in the hands of the high-income investors so long as these losses exist and then, when depreciation decreases and operating profits appear, to get the profits in the hands of the General Partners. Of course it cannot be done this boldly without running afoul of the IRS. Therefore the flip-flop is never complete -- that is, the General Partners don't end up with 99% of the project but with, for example, 50%. Further, the turnover date is usually described in neutral terms. Thus the Conversion Date is often defined in terms of return of original investment which can be justified to the IRS as a time when the outside investors have reduced their investment to a point warranting a smaller interest in profits and losses. A Conversion Date based on 20 years from the Final Mortgage Endorsement can also be justified economically because at that point the FHA allows the mortgage to be refinanced.

88 . Profits upon sale are apt to be paper profits just as early operating losses were paper losses and for the same reason -- depreciation deductions. Profits are illusory since often more money is owed in taxes than is left of the sales price after the mortgage is paid off.

Article 11.2(c)(6) shall be shared by the Partners as follows: [89]

First, by the Limited Partners, an amount of such profits equal to the excess, if any, of (1) the aggregate losses charged and cash distributions paid to the respective capital accounts of the Limited Partners prior to the date on which such allocation is made, over (2) the sum of the aggregate profits credited to their respective capital accounts prior thereto and the aggregate of their respective capital contributions theretofore made;

Second, by the General Partners, an amount of such profits equal to the excess, if any, of (1) the aggregate losses charged and cash distributions paid to the respective capital accounts of the General Partners prior to the date such allocation is made, over (2) the sum of the aggregate profits credited to their respective capital accounts prior thereto and the aggregate of their respective capital contributions theretofore made;

Third, by the Limited Partners, an amount of such profits equal to the amount, if any, by which the aggregate capital contributions of the Limited Partners exceed the total amount of all prior distributions made to them pursuant to this Partnership Agreement.

Fourth, by the General Partners, an amount of any such remaining profits equal to the amount, if any, by which the aggregate capital contributions of the General Partners plus the amount distributed to General Partners pursuant to Article 11.3(b) Second exceed the total amount of all prior distributions made to the General Partners pursuant to this Partnership Agreement.

Fifth, any balance of such profits, 50 percent by the Limited Partners and 50 percent by the General Partners.

Sixth, any loss shall be allocated pursuant to Article 11.1(a) until the capital accounts of the Limited Partners show a negative

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89 . This makes explicit how the tax profits and losses will be allocated. This is different from the allocation of the distributable cash (if any). The tax consequences of these allocations are important, and an accountant should be consulted about the wording and its implications.

balance and thereafter shall be charged to the General Partners.

(c) The profits and losses of the Partnership allocated to a particular class of Partners shall be shared by the Partners comprising such class in proportion to their respective Partnership Interests, as shown on Schedule A.

(d) All profits and losses shared by the Partners shall be credited or charged, as the case may be, to their capital accounts as of the date at which such profits and losses are to be determined. The profits and losses of the Partnership allocated among the Partners, other than profits and losses of the Partnership arising from the sale or other disposition of all or substantially all of the assets of the Partnership, shall be credited or charged to their respective capital accounts prior to the allocation of profits and losses of the Partnership arising from such sale or disposition.

(e) All profits and losses shall be determined in accordance with the accounting methods followed by the Partnership for federal income tax purposes.

11.2 Net Partnership Receipts of the Partnership

(a) The Net Partnership Receipts of the Partnership shall be determined for each fiscal year and for the portions of the fiscal years in which either Final Endorsement or the Conversion Date occurs, as the case may be, and, subject to the Regulatory Agreement, after Final Endorsement shall be promptly distributed as follows:

(1) For each fiscal year or portion thereof through the Conversion Date, 90 percent to the Limited Partners, and 10 percent to the General Partners.

(2) For each fiscal year or portion thereof after the Conversion Date, 50 percent to the Limited Partners and 50 percent to the General Partners.

Provided, however, that, during such time as the Regulatory Agreement is in effect, the total amount of Net Partnership Receipts which may be so distributed during any fiscal year shall not exceed the Annual Distribution, defined below.

(b) If the Net Partnership Receipts of the Partnership for any such fiscal year which are being distributed pursuant to Article 11. 2(a) are less than the Annual Distribution for such year, such Net Partnership Receipts of the Partnership shall be distributed first to the Limited Partners up to 90 percent of the Annual Distribution for each year or portion thereof through the Conversion Date and up to 50 percent of the Annual Distribution for each year or portion thereof after the Conversion Date, and any balance of such Net Partnership Receipts of the Partnership shall be distributed to the General Partners. If the Net Partnership Receipts of the Partnership for any such year which are being distributed pursuant to Article 11. 2(a) are more than the Annual Distribution for such year, such Net Partnership Receipts of the Partnership shall be distributed in the following order:

(1) to the General and Limited Partners pursuant to Article 11. 2(a) up to the Annual Distribution.

(2) at the discretion of the General Partners, any balance of such Net Partnership Receipts of the Partnership may be applied to the payment of loans to the Partnership made pursuant to Article 5. 7 up to an amount equal to the unpaid principal amount thereof and any interest thereon.[90]

(3) any balance of such Net Partnership Receipts permitted by the Regulatory Agreement to be distributed shall be distributed 90 percent to the Limited Partners and 10 percent to the General Partners for each fiscal year or portion thereof through the Conversion Date, and, for each fiscal year or portion thereof after the Conversion Date, 50 percent to the Limited Partners and 50 percent to the General Partners.

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90 . This agreement gives a first priority to the payment of the Annual Distribution (the limited dividend). Another group might decide to pay off the loans first before any other distribution.

If 90 percent of the Annual Distribution for each year or portion thereof through the Conversion Date and 50 percent of the Annual Distribution for each year or portion thereof after the Conversion Date is not distributed to the Limited Partners, Net Partnership Receipts of the Partnership for subsequent fiscal years shall be distributed first to the Limited Partners up to the entire amount of such deficiency before any distribution of such Net Partnership Receipts of the Partnership is made pursuant to the foregoing provisions of Article 11. 2(a). [91]

(c) Definition of Net Partnership Receipts. For all purposes of this Agreement, the term "Net Partnership Receipts" shall mean the profits from the Partnership from and after Final Endorsement, other than those arising from the sale or other disposition of all or substantially all the Partnership assets, as determined for purposes of Article 11. 1, but subject to any applicable Regulations and further subject to the following: [92]

(1) Depreciation of building, improvements, and personal property and amortization of any financing fee shall not be considered as a deduction.

(2) Mortgage or other loan amortization shall be considered as a deduction.

(3) Amounts paid into the reserve fund for replacements pursuant to the Regulatory Agreement shall be considered as a deduction. [93]

(4) If the General Partners shall so determine, an additional reasonable reserve may be maintained and additions thereto shall be considered as a deduction to

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91 . This clause means that the Annual Distribution is accumulative and that the accumulated arrears have actual first priority out of each year's receipts.

92 . Net Partnership Receipts are thus essentially the cash flow; the money that comes in from rents less cash outlays.

93 . FHA requires .006 % of the cost of replacement of the structure as a reserve.

provide for working capital needs, funds for improvements or replacements or for any other contingencies of the Partnership. But payments from the fund shall not be deducted. [94]

(5) Any amounts paid by the Partnership for capital expenditures or replacements shall be considered as a deduction, unless paid by cash withdrawal from any replacement reserve for capital expenditures set up in subsections (3) and (4) above.

(6) Capital contributions to the Partnership, the proceeds of any mortgage refinancing, the profits and losses from any sale, exchange, eminent domain taking, damage or destruction by fire or other casualty, whether insured or uninsured, or other disposition, of all or any part of the Property, shall not be included in Net Partnership Receipts. [95]

(7) Payments to the Partnership or to the Mortgagee by HUD or any other federal or state agency in the form of interest reduction or other subsidy payments shall be included in Net Partnership Receipts.

11.3 <u>Other Distributions</u>

(a) Prior to one year [96] after Final Endorsement of the Project and subject to any applicable Regulatory Agreement, if the

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94 . Thus, the payments into the reserve fund reduce the available cash for distribution in a given year. Payments out of the reserve fund do not affect that year's available operating money.

95 . These items are treated in the annual profit and loss statement for tax purposes as receipts of the Partnership. Since they are not so treated for distribution purposes, it is possible that the amount subject to taxation will differ from the amount the partners will receive.

96 . This is somewhat arbitrary, but should be dated after last capital contribution.

General Partners shall determine that excess cash is available for distribution from (i) proceeds of the Mortgage Loan, (ii) receipts from operations of the Partnership prior to Final Endorsement, all such cash available for distribution shall be distributed to the General Partners pursuant to Article 5. 9(f).

(b) From Final Endorsement until just prior to termination of the Partnership and subject to any applicable Regulatory Agreement, all cash available for distribution from all sources except Net Partnership Receipts and the capital contributions of Limited Partners shall be distributed as follows:

First, such cash shall be distributed to the class comprised of the Limited Partners up to the amount, if any, by which the aggregate capital contributions of the Limited Partners exceed the aggregate total amount of all prior distributions made to the Limited Partners pursuant to this Agreement. [97]

Second, such cash shall be distributed to the General Partners up to the amount, if any, by which the aggregate capital contributions of the General Partners exceed the aggregate distributions made to the General Partners pursuant to this Agreement.

Third, fifty percent (50%) of any balance of such cash shall be distributed to the Limited Partners and 50 percent of such cash shall be distributed to the General Partners.

11. 4 Allocation of Distributions Among Partners

(a) Distributions to a particular class of Partners shall be shared by the Partners comprising such class in proportion to their respective Partnership Interests as shown in Schedule A.

(b) All distributions to the Partners shall be charged to their respective capital accounts. All distributions to the Partners pursuant to the provisions of Articles 11. 2 and 11. 3 shall be made and charged to their respective capital accounts prior to the allocation of profits and losses pursuant to Article 11. 1(b).

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97 . This will made the Conversion Date occur sooner. Care must be taken to avoid freak circumstances where Conversion takes place while substantial tax losses for the Partnership still exist.

11.5 Conversion Date. "Conversion Date" shall mean the earlier of (i) twenty (20) years after the date of Final Endorsement or (ii) the first date on which the Investor Limited Partners shall have received a distribution of cash proceeds available for distribution from the refinancing of any mortgage on or the sale, exchange, condemnation (or similar eminent domain taking), casualty or other disposition of all or a substantial part of the Property, which, together with all prior distributions to the Investor Limited Partners, equals or exceeds the aggregate capital contributions of the Limited Partners.

11.6 Annual Distribution. "Annual Distribution" means six percent (6%) of the Equity Investment at Final Endorsement plus such additional amounts as the Regulations, as they may be amended from time to time, permit to be distributed.

11.7 Equity Investment. "Equity Investment" means $________,[98] or such amount as shall be adjusted pursuant to the HUD or other applicable Regulatory Agreement upon completion of the Project.

12. ACCOUNTING

12.1 Books and Records. The General Partners shall maintain full and accurate books of the Partnership at the Partnership's principal place of business, showing all receipts and expenditures, assets and liabilities, profits and losses, and all other records necessary for recording the Partnership's business and affairs, including those sufficient to record the allocations and distributions specified in Article 11 and those required in order to elect depreciation as provided in Article 11.5 and to retain such election. The books of the Partnership shall be kept on an accrual basis. Such books and records shall be open to the inspection and examination of all Partners in person or by their duly authorized representative at reasonable times.

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98 . The "Equity Investment" is normally the implied equity (10% of the Replacement Cost or 11.1% of the Mortgage). Under certain circumstances, FHA will allow a 6% return on the true capital contribution of the Partners which can exceed the implied equity.

12.2 Fiscal Year. The fiscal year of the Partnership shall be the calendar year.[99]

12.3 Reports. Annual statements shall be prepared at the end of the fiscal year and furnished to each Partner showing income and expenses of the Partnership and the capital accounts of the Partners. In addition, within 90 days after the end of each calendar year, a report setting forth in sufficient detail such information and data with respect to business transactions effected by, or involving, the Partnership during such calendar year as shall enable such Partner (or his representatives) to prepare his State and Federal Income Tax returns in accordance with the laws, rules, and regulations then prevailing shall be mailed to each Partner (or his designated representative).[100]

12.4 Accounting Decisions. Any decisions as to accounting principles, except as otherwise specifically provided herein, shall be made by the General Partners in accordance with generally accepted accounting principles. The General Partners shall elect for the Partnership depreciation on its property, for tax purposes, on the most accelerated method available under applicable law and shall make the maximum use of tax deductions, credits and the like, so long as it is in accordance with generally accepted tax accounting principles. All costs incurred during the construction period which may be expensed for tax purposes shall be treated as expenses rather than as capital items.

12.5 IRS Election. The Partnership shall elect Section 754 of the Internal Revenue Code of 1954 (or corresponding provisions of succeeding law).

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99 . There may be a reason to choose a fiscal year other than the calendar year.

100 . It would be useful for the Limited Partners to receive an estimate in November in order to do year-end tax planning.

13. SALE OF ASSETS [101]

14. DISSOLUTION

14. 1 Distribution on Dissolution. Upon the dissolution of the Partnership pursuant to Article 4. 2, the General Partners shall liquidate the Partnership and the proceeds of such liquidation shall be applied and distributed in the following order of priority:

(a) To the payment of debts and liabilities of the Partnership, the expenses of liquidation, and the repayment of any loans made by the General Partners that are still outstanding.

(b) To the setting up of any reserves which the General Partners may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Partnership, arising out of or in connection with the Partnership.

(c) To the payment to Limited and General Partners of their share of the Partnership's Net Operating Receipts which are distributable to such Partners pursuant to Article 10. 1 on account of the period immediately preceding liquidation but which have not yet been distributed to such Partners.

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101 . This Article is left blank because there is disagreement over the desirability of providing in detail for sale of the Project. Some agreements specifically call for sales to the Local Partner or the tenants or other community groups at an agreed upon price such as $1 over the remaining mortgage. The advantage to the community of a predetermined low price is obvious. The danger in this kind of provision is that the Internal Revenue Service may then view the whole transaction as a sham insofar as the Limited Partners are concerned. They would argue that the Limited Partners never had real ownership of the building and were thus not entitled to take the depreciation deductions. Thus, it will be the Limited Investors that will object to such a sales provision unless an advance ruling can be gotten from the Service that depreciation will be allowed.

(d) Any balance then remaining shall be distributed among the General and Limited Partners in accordance with Article 11.2(b).

14.2 Period for Orderly Liquidation. A reasonable time shall be allowed for the orderly liquidation of the assets of the Partnership and the discharge of liabilities to creditors so as to enable the General Partners to minimize the normal losses attendant upon a liquidation.

14.3 Records of Liquidation. Each of the Partners shall be furnished with a statement prepared by the General Partners which shall set forth the assets and liabilities of the Partnership as of the date of complete liquidation. Upon the General Partners' complying with the foregoing distribution plan, the Limited Partners shall cease to be such, and the General Partners, as the sole remaining Partners of the Partnership, shall execute, acknowledge, and cause to be filed a writing to cancel the Certificate of Limited Partnership of the Partnership.

14.4 Liability of the General Partners. The General Partners shall not be personally liable for any Article 14 distributions to Limited Partners, or any portion thereof including a return of invested capital, all such distributions being solely from Partnership assets.

15. GENERAL PROVISIONS

15.1 Identification of Government Agencies, Statutes, Programs, and Forms. Any reference in this Agreement, by name or number, to a government agency, statute, program, or form shall include any successor agency, statute, program, or form.

15.2 Partners Independently Bound. Each Partner shall become bound by this Agreement immediately upon affixing its signature hereto and independently of the signature of any other Partner.

15.3 Addresses and Notices. The Address of the Partnership shall be its principal office. The Address of each Partner for all purposes shall be the address set forth on the signature page on this Agreement, or such other address of which the General Partners have received written notice. Any notice, demand, or request required or

permitted to be given or made hereunder shall be deemed given or made when delivered or sent by certified or registered mail to such Partner at such address.

15.4 Titles and Captions. All article or section titles or captions in this Agreement are for convenience only and shall not be deemed part of the context of this Agreement.

15.5 Pronouns and Plurals. All pronouns and variations thereof shall be deemed to refer to the masculine, feminine, neuter, singular, or plural as the identity of the person or persons may require.

15.6 Further Action. The Parties shall execute and deliver all documents, provide all information, and take or forbear from all such action as may be necessary or appropriate to achieve the purposes of this Agreement.

15.7 Applicable Law. This Agreement shall be interpreted in accordance with the laws of [the state in which the Project is located.] [102]

15.8 Arbitration. Any dispute arising out of or in connection with this Agreement or the breach thereof shall be decided by arbitration in accordance with the then prevailing commercial arbitration rules of the American Arbitration Association and judgment thereon may be entered in any court having jurisdiction thereof. [103]

15.9 Agreement Binding. This Agreement shall be binding upon the Parties and their heirs, executors, administrators, successors, and assigns.

15.10 Entire Agreement. This Agreement contains the entire understanding between the Parties and supersedes any prior understandings and agreements respecting the subject matter of this Agreement.

15.11 Waiver of Trial by Jury. The Parties hereby waive trial by jury in any action, proceeding, or counterclaim brought by any Party against any other Party in any matter arising out of or in any way

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102. Or in which the investors are situated.

103. This is a standard arbitration clause but is not the best for real estate deals. Some states will not allow any arbitration for real estate deals so some acceptable alternative dispute settlement procedure must be chosen. See footnote 54 for more on arbitration.

connected with the subject matter of this Agreement.

15.12 Amendment. This Agreement may be modified or amended only with the written approval of all Partners. [104]

15.13 Creditors. None of the provisions of this Agreement shall be for the benefit of or enforceable by any creditors of the Partnership.

15.14 Saving Clause. Any provisions of the National Housing Act or the Regulatory Agreement which supersede any provision hereof shall not affect the validity of the balance of this Agreement, and the remaining provisions shall be enforced as if the invalid provisions were deleted.

15.15 Agreement in Counterparts. This agreement may be executed in several counterparts and all so executed shall constitute one agreement, binding on all the Parties hereto, notwithstanding that all the Parties are not signatory to the original or the same counterpart so long as one General Partner has signed any document purporting to be a good counterpart.

IN WITNESS WHEREOF, this Agreement has been duly executed by the Parties on the _____ day of _____________, 19____.

GENERAL PARTNER:

______________________________	______________________________
(Signature)	(Print Name)
______________________________	______________________________
(Print Residence Street Address)	(Print City and State)

GENERAL PARTNER:

______________________________	______________________________
(Signature)	(Print Name)
______________________________	______________________________
(Print Residence Street Address)	(Print City and State)

104 . If the number of Limited Partners is large it may be desirable to require only a certain percentage of approval (e. g., 80%) to prevent a single recalcitrant objector from having veto power.

LIMITED PARTNER: [105]

(Signature)	(Print Name)	(No. of Units)
(Print Residence Street Address)	(Print City and State)	

LIMITED PARTNER:

(Signature)	(Print Name)	(No. of Units)
(Print Residence Street Address)	(Print City and State)	

105 . Either in this document or a separate subscription agreement, the social security number, business address (with choice of mailing address), and bank reference should be obtained for each Limited Partner.

ABOUT THE AUTHORS

Robert H. Kuehn, Jr., has specialized in the area of low- and moderate-income housing since 1965. He holds degrees in architecture and urban studies from Yale University and studied housing economics as a Fullbright Fellow at the University of London. He coauthored "An Economic Analysis of the Housing and Urban Development Act of 1968" which was published by the Harvard Business School where he was formerly a research associate. He is also the author of several papers related to low- and moderate-income housing and has taught a series of seminars on housing at M. I. T. Mr. Kuehn has worked as a housing consultant for various private companies and government agencies before forming Housing Economics in 1970, a company that offers consulting services relating to housing, especially the financial and tax aspects of development. The company's clients include both private developers and CDCs.

Melvin Epstein is responsible for financial issues in community economic development at CCED. In the course of his work he has assisted CDC and other community groups in financing and feasibility planning for major development projects such as cable television stations, multi-family housing, and shopping centers. Previously, Mr. Epstein was a member of the investment banking department of Meller and Company, members of the New York Stock Exchange, where he worked on public and private offerings from the initial valuation analysis stage to syndication. Mr. Epstein holds master's degrees in finance (Stanford University) and in sociology (New School for Social Research). He recently served on a task force established by the Office of Economic Opportunity to determine how OEO should use its research and development funds in the real estate area. In addition, he is a faculty member at the Cambridge Goddard Graduate School where he teaches a course on urban planning and human needs. He is coauthor of "Growth Industries and Project Selection" (CCED, 1971) and coauthor of Housing Development: A Tool for Development in Low-Income Areas (CCED, 1971).

Susan Horn-Moo is presently staff attorney at CCED with responsibility for the legal component of all research project. Her special interest lies in issues of land development for CDCs. She has worked in the housing area for over a year and has assisted several CDCs with negotiating problems with land developers. Previously she worked as a tax and corporate attorney with the Boston firm of Bingham, Dana and Gould. While in law school Ms. Horn-Moo worked with the Cambridge Legal Assistance Office which aids community groups and individuals unable to pay for legal services. Ms. Horn-Moo is a graduate of Harvard Law School and Wellesley College.

The Center for Community Economic Development (CCED) is an independent research group located at 1878 Massachusetts Avenue, Cambridge, Massachusetts 02140. Its primary function is to conduct public policy research by examining the ongoing problems of community development corporations (CDCs) and of other community-based economic organizations. A CDC is a corporation based in one geographic area and controlled democratically by the residents. It can (and does) own stores, housing, factories, and so forth on behalf of the community. It usually attempts simultaneously to develop social services. When profits are made, many CDCs attempt to shift at least part of these directly into a variety of neighborhood-building activities.

CCED acts also as a clearinghouse and library for materials and information on community-based economic development, and it has assisted CDCs as an advocate on social and economic problems. Its work is supported primarily by a grant from the United States Office of Economic Opportunity.

Opinions expressed in this paper are those of the authors and should not be construed as representing the opinions or policy of any agency of the United States government.

This is one of a series of publications. A complete list of publications is available upon request.